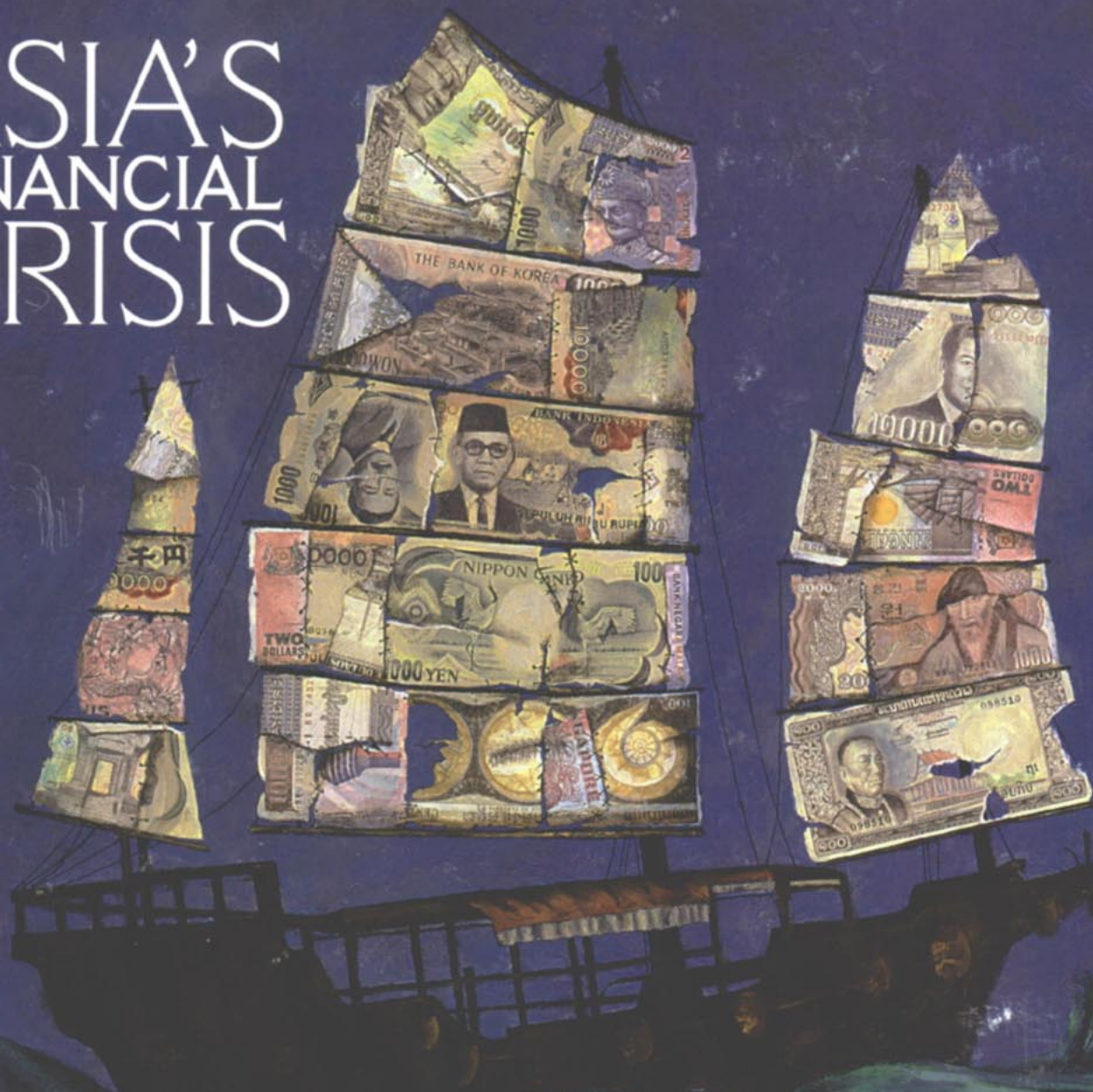


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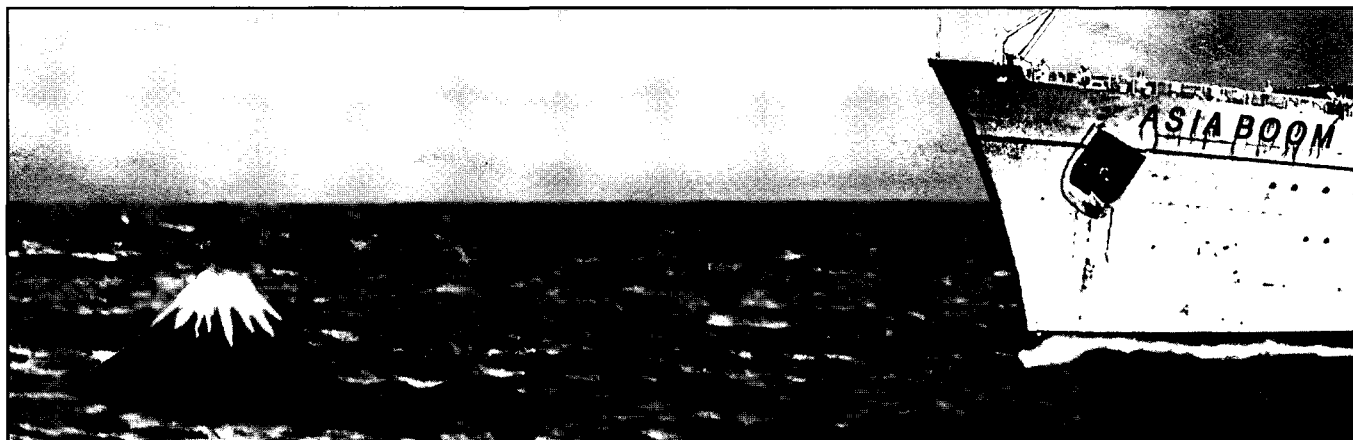
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Asia Is Still Our Future
Walter F. Mondale

COVER ILLUSTRATION BY FERRUCCIO

Asia Is Still Our Future

In one of the few recent books on Indonesia, *A Nation in Waiting*, author Adam Schwarz writes: "With over 180 million inhabitants, Indonesia's population trails only China, India, and the United States. And yet . . . Indonesia is all but invisible to most of the West and only scarcely better understood in Asia."

This year, that otherwise low profile rose dramatically as stories about the economic

crisis in Indonesia became a fixture in the international press. In early March, when I traveled to Jakarta as President Clinton's special envoy to President Suharto, I had the opportunity both to witness and to participate in the world's new-found interest in Indonesia.

Everyone is now well aware of the economic troubles in Indonesia and throughout much of Asia, a region heretofore known for its awesome economic growth.

Beginning last summer, turmoil in the Asian financial markets

pushed that region into its most serious crisis in decades. With stunning and unexpected speed, the crisis drove many economies, especially Thailand, South Korea, and Indonesia, from robust growth to recession—at a time when Japan's economy had been in the doldrums for most of the 1990s.

The crisis in Asia was triggered by vulner-

abilities in the economic and political systems of these countries—including chronic overcapacity in production, expensive but unneeded infrastructure projects, rampant corruption, massive corporate and bank debt, and overdependence on foreign capital. The problems proved much worse than anyone anticipated and, when exposed, caused a rapid erosion of confidence in the Asian economies.

We suffered the rude discovery that the financial systems which had fueled the early dramatic economic growth of these nations proved inadequate when it came to managing the much more complex and sophisticated economies that had developed.

The rest, as they say, is history.

What happens next in Asia is a matter of great concern. My years as U.S. ambassador in Japan convinced me of the centrality of Asia to the future interests of the United States and the world. Asia constitutes an ever larger share of the global economy, and it has been a rapidly growing market for American exports. Despite this current setback, Asia is still our future.

The main actors in Asia's economic recovery must be the Asian nations themselves, especially Japan (with an economy twice that of the rest of Asia combined). But, as the largest economy in the world and one that itself belongs to the Asia-Pacific region, the United States must do its part to ensure that this drama will not have a tragic ending.

I am old enough to have lived through three major wars fought by Americans in Asia. If the region's economic problems persist, they could feed into social unrest, political instability, economic rivalries, and territorial disputes. All would exacerbate the potential in the region for serious con-



Walter F. Mondale was vice president of the United States from 1977 to 1981. He was U.S. ambassador to Japan from 1993 to 1996.

WALTER F. MONDALE

frontation, even armed conflict, that would inevitably affect American interests.

We also have a moral obligation to see that the people of Asia are not left to the mercy of economic troubles not entirely of their own making. After all, many in the West—governments, investors, the media—helped foster the environment for Asia's sharp reversal of fortunes. Eager to proclaim Asia an economic miracle, we all too gladly overlooked the region's vulnerabilities and helped overheat its investment climate. Now, as many in the West are quick to declare Asia an economic disaster area, we run the risk of unwisely deserting these countries, many of whose economic fundamentals remain solid.

In response to the crisis, the International Monetary Fund and the major economies of the world have urged the troubled Asian economies to take steps to restore stability and establish the foundation for sustained economic recovery.

Full recovery in Asia will require vigorous American leadership, especially in multilateral institutions such as the IMF. The IMF's financial assistance has provided much-needed breathing room for Asia's economies and has been essential leverage in persuading these countries to accept major domestic reforms. The reforms, if fully implemented, offer Asian economies their best chance to resume impressive growth on a sustainable basis.

But America's hesitant, miserly posture in meeting our commitments to the IMF threatens to put the vulnerable Asian economies at further risk. It also undercuts America's indispensable leadership role throughout the world. Experts can argue about details, but to the extent that the IMF needs to improve its procedures and pro-

grams, the United States is better served if we keep our credibility and voice within the institution by making good on our commitments to it.

It does neither Asia nor the United States any good for us to withhold support for the IMF in the midst of a crisis. As Treasury Deputy Secretary Larry Summers recently noted, it makes as much sense as canceling a life insurance policy after being diagnosed with a serious illness.

In addition to U.S. leadership, full recovery in Asia will require a growing and more open Japanese economy. Just as the open, growing U.S. market proved crucial to Mexico's recovery several years ago, Japan must provide the same leadership for Asia.

The basic challenge posed by the economic turmoil in Asia remains: will these nations move ahead with market-oriented reforms and accept the discipline that comes from international competition and integration with the global economy? Or will they simply tinker around the edges of the problem, leaving in place the "crony capitalism" that led to their troubles? This is not a minor question. Real reform will mean not only making big economic changes, but also departing from deeply entrenched political and cultural practices.

Blessed are the uses of adversity, Shakespeare once wrote. If Asia's financial crisis does lead to fundamental reform, it may well prove a blessing in disguise. Reform would not only restore stability and ensure recovery from the crisis, but also put these nations on the path to sustainable economic health. In turn, this would promote a more open system of global trade and finance that would be a boon for the United States and the rest of the world as well. ■

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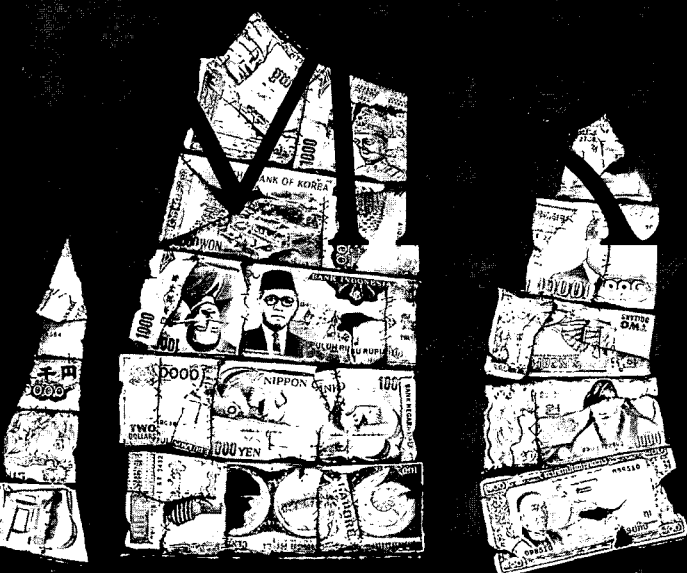
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Exploring the Asian Financial Crisis

by Edward J. Lincoln

MIRACLE

Much U.S. press commentary on the crisis in Asia has been tinged with relief; Asia turned out to be less of a challenge to Western neoclassical economic concepts than had been feared. But any analysis of Asia should begin with the recognition that the miracle was real. Over the past three decades, economic growth in many Asian economies has been high on a sustained basis, average standards of living have increased greatly, and the incidence of abject poverty has fallen rapidly. Heavy government intervention in markets through state-directed financial credit and regulation may have had flaws, but it produced an incredible period of sustained economic growth and industrial transformation. Now those societies must grapple with difficult questions of how much reform they must undertake to restore their nations to healthy economic growth and how much reform they can tolerate while remaining true to their broader social ideals. As Ambassador Walter Mondale eloquently points out, Asia matters greatly to us, and the nations of the region deserve our attention and assistance in their struggle to return to economic health.

Press coverage also tends to speak broadly about the Asian crisis, as though it were a single phenomenon. In reality, problems vary widely across the region. If a common thread weaves through most of Asia, it is a combination of weakly developed domestic banking systems exposed to deregulation of international capital flows. Many Asian countries have relied much more heavily on banking than on bond and stock markets to mediate the flow of financial resources. They have also lagged in developing credit risk analysis, either because of strong state guidance over commercial bank lending or because of a reliance on personal relationships rather than analysis. Permitting weak banking systems to borrow internationally in the 1990s—from sources not well informed about local problems—turned out to be a fatal flaw, as Brookings's Barry Bosworth explains.

These problems were particularly acute in Southeast Asia, as detailed by Stephen Parker, chief economist for the Asia Foundation. Economies that were tending to overheat and lose international export competitiveness began borrowing heavily abroad. Most of the borrowing was private rather than government, and much was in the form of short-term bank

Economists and political scientists spent considerable energy in the past decade explaining the Asian economic miracle—the ability of so many Asian countries to sustain high growth and industrial transformation. Until last year few gave much thought to problems or distortions in Asia's development process.

Last summer, the problems began bursting to the fore, starting with Thailand and reverberating across large portions of Asia. Now the need is to explain what went wrong and to analyze the many possible implications of the Asian financial crisis. This issue of the *Brookings Review* brings together a wide range of views on the causes, implications, and possible cures for Asian problems.

Edward J. Lincoln is a senior fellow in the Brookings Foreign Policy Studies program. He is the author of Japan's New Global Role (Brookings, 1993).

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borrowings, creating a volatile situation. Southeast Asian countries had only weakly developed control of private-sector banking systems, and governments proved poorly equipped to deal with the result. Thailand and Indonesia have turned to the International Monetary Fund because of the resulting acute international debt problems, but Malaysia, Singapore, and the Philippines have experienced some problems as well.

South Korea also had to turn to the IMF for aid. Problems there stemmed mainly from unrealistic expectations about manufacturing export growth—expectations that were shattered when depreciation of the Japanese yen after early 1995 made Japanese products more price competitive with Korean exports. Korea's international liquidity problem peaked last December, and newly elected President Kim Dae Jung now faces the problem of carrying out extensive economic reform. Yung Chul Park, of Korea University and the Korean Institute of Finance, analyzes the situation in Korea.

Some in Asia hope that Japan can help lead the region to recovery. But Japan has its own problems. Ever since the dramatic collapse of real estate and stock prices after 1990, it has struggled with economic stagnation, large amounts of bad debt, and a political system that seems unable to cope with the economic troubles. Japan, like other nations in the region, suffered from excessive reliance on a poorly developed banking system—though rather than borrowing from abroad, the banking system compounded its problems by lending abroad as unwisely as at home, becoming a major lender to other Asian countries. Japan's continued economic stagnation coupled with its own currency depreciation implies that it will not absorb rising imports from the rest of the region to underwrite their recovery strategies. Robert Feldman, chief economist for Morgan Stanley in Tokyo, discusses Japan's distressing long-term malaise.

What happens in Asia has serious implications for the United States. On the one hand, the decline in Asian currencies has helped curb U.S. inflation at a time when a prolonged economic expansion and low unemployment would normally unleash it. On the other hand, weakness across Asia depresses American exports while the fallen exchange rates are increasing American imports. But so far the interplay of these factors has not seriously affected U.S. economic growth, and even the widening trade deficit has as its flip side an increased inflow of capital that fuels investment and growth (explored further later in the issue by Robert Lawrence). If the United States has a problem, it is one of political leadership, evidenced in the debate in Congress over additional funding for the IMF. David Hale of the Zurich Group explores the effects, economic and political, of the Asian crisis on the United States.

One rather neglected issue is direct investment. Developing countries in Asia attracted foreign direct investment as part of their growth strategies. And though a key element in the Asian crisis was the flight of foreign capital, direct investment remains strong. Certainly foreign investors who entered to produce for the local market have been hurt by the economic

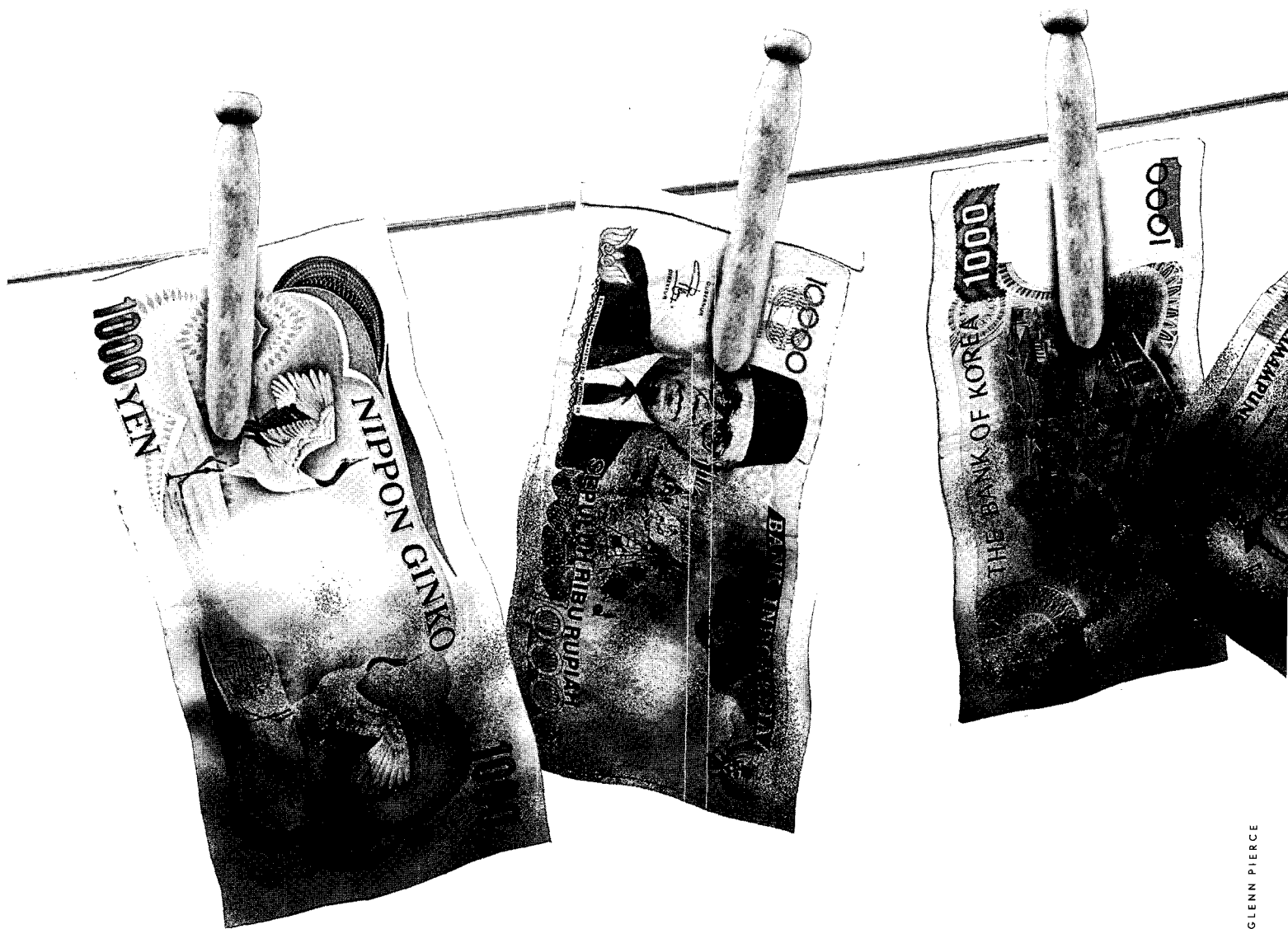
downturn. But Asian countries are now even more actively competing to attract foreign investment in manufacturing to boost exports. With weak exchange rates, some Asian countries have become more attractive to multinationals seeking low-cost production bases. Dennis Encarnation of Harvard looks at direct investment across the region.

How does the plunge, in much of Asia, from stunning economic growth to stagnation or contraction affect regional security relations? Internal turmoil, especially in Indonesia, is one concern. Internationally, economic crisis increases the flow of migrant workers—pushing more workers to seek jobs abroad while simultaneously lowering government tolerance for an inflow of workers. Meanwhile, the crisis affects still-tense relations on the Korean peninsula and could affect great-power relations. Brookings's Mike Mochizuki considers this thicket of security issues.

Many Americans also worry about the rising U.S. deficit with Asia. High or rising bilateral or global trade and current account deficits have often been a hot political issue in the United States, and a possible deterioration of the U.S. current account deficit by \$100 billion this year could reignite it. But Robert Lawrence, of Harvard and Brookings, argues that so long as the rising current account deficit (and reciprocal increase in net capital inflow from the rest of the world) finances increased investment in a growing U.S. economy, the rising deficit should not be a matter of concern.

Finally, the Asian financial crisis has spawned a vigorous debate in Washington over the role of the IMF. At the extremes, some conservatives oppose the IMF out of a generalized antipathy to all multilateral institutions, and some liberals want to encumber it with a strong social agenda. In the middle ground, debate focuses on appropriate policy responses to international financial crises. Some argue that the unanticipated political and economic costs arising from such crises make the IMF necessary in devising bailout plans to keep the pain in affected countries within tolerable bounds. Others argue that in an Asian-style crisis, in which most of the indebtedness was incurred by the private sector rather than by governments, any bailout raises serious moral hazard problems since risk and the acceptance of risky outcomes must be a central feature of capitalist markets. Representing this debate here are Robert Hormats, of Goldman, Sachs, and Co., Lawrence Lindsey, of the American Enterprise Institute, and Barry Bosworth of Brookings. The larger debate will go on for some time, but the likely outcome will be reform of the IMF, at least redefining its procedures (to make them more transparent) and possibly redefining its overall role.

As is obvious from this lineup of articles, the Asian financial crisis is a broad phenomenon. The most acute phase of currency crisis appears to have passed, but now the nations of the region must deal with the real economic consequences of what happened in 1997. The region will recover, but how rapidly remains unknown—and entails the many issues raised in this *Brookings Review*. ■



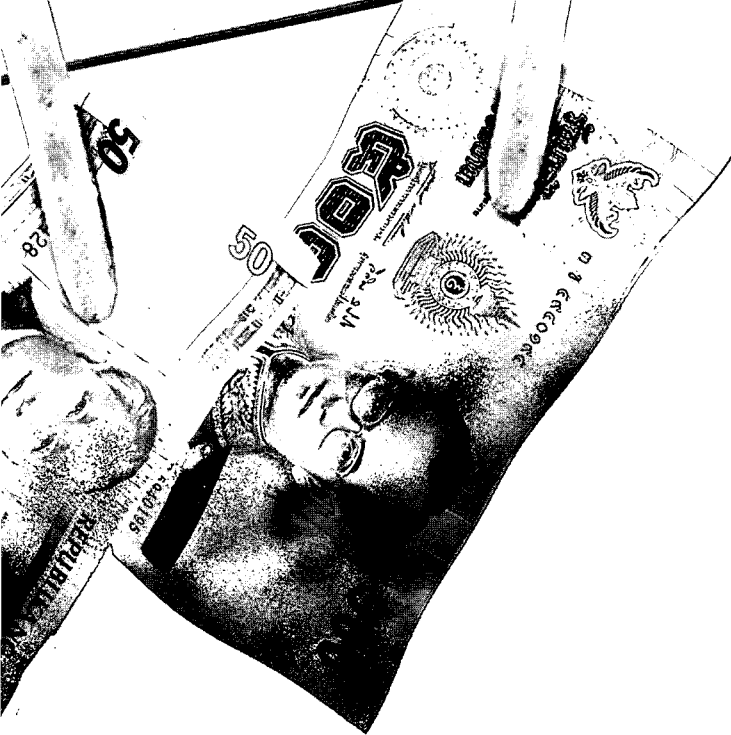
GLENN PIERCE

LAST YEAR'S DRAMATIC ASIAN EXCHANGE RATE COLLAPSES have intensified efforts to understand and control the forces behind such crises. Until recently economists blamed currency crises on distorted domestic macroeconomic conditions. But the Asian crises grew out of quite different economic subsoil—namely, microeconomic weaknesses in domestic banking systems and unprecedented exposure to exchange rate risk by those who borrowed in foreign markets.

THE ASIAN FINANCIAL

What Happened and What We Can Learn from It

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Currency crises are not uncommon. Barry Eichengreen, Andrew Rose, and Charles Wyplosz identified 78 such crises in advanced countries during 1959–93, while Jeffrey Frankel and Rose found 117 crises in 105 developing countries between 1971 and 1992. Most were minor, especially by the standard of recent events in Asia, and many were actually good news in that output grew rapidly in the year after the crisis. The Asian crisis, like the 1995 currency crisis in Mexico, has been far more costly. The two differ from earlier crises in at least two other ways: they reflect problems of liquidity rather than solvency, and they involve severe distortions in the domestic financial system. Both show how the combination of open capital markets, with their potential for large cross-border capital flows, and the liberalization of previously repressed financial institutions creates a potent brew for a currency crisis.

SOLVENCY VERSUS LIQUIDITY

In the wake of World War II, the world economy grew through expanded trade in goods and services. Capital transactions between national markets were strictly controlled and limited to direct investment and a little bank lending, generally to governments. Exchange rate crises involved a simple flow disequilibrium. A country's spending would gradually exceed its income, a current account deficit would result, and at some point lenders would doubt the sustainability of its borrowing. The country was living beyond its means in ways that raised basic questions of solvency—the ability to pay its bills.

The International Monetary Fund became adept at dealing with these flow-driven currency crises. It provided short-term loans to cover current account deficits and helped countries restore balance, usually through devaluing the currency and realigning fiscal and monetary policies to scale back domestic demand. Financing costs were small, and the adjustment often translated into growth in real output and employment.

The Asian crisis, however, unfolded in a world of increasing capital mobility. In the early 1970s, the United States dropped its controls on capital movements, and most other industrial countries followed suit within a decade. Today developing countries are under increasing pressure to allow the free flow of financial capital across their borders. Investors are seeking to allocate a stock of wealth globally among national assets that are increasingly substitutable with one another. When news or the pressure of events causes investors to reallocate their assets, the resulting short-term demands on a country's foreign exchange reserves far exceed anything envisioned in the old regime of limited capital mobility. The problem is not just the reversibility of past foreign capital inflows, but the potential for capital flight as domestic wealth holders and foreign short-term creditors suddenly seek to convert their assets to foreign currencies. The issue is not solvency but liquidity—indeed, Asia's crisis resembled an old-fashioned bank run.

Before 1995, the largest IMF stand-by credit arrangement was a \$4 billion agreement with the United Kingdom in

Barry Bosworth is a senior fellow in the Brookings Economic Studies program.

CRISIS

By Barry Bosworth

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1977. The 1995 agreement with Mexico was far larger—IMF funds of \$17.7 billion were just one part of a \$52 billion multilateral package. Last year's three Asian agreements—with South Korea, Indonesia, and Thailand—have drawn \$35 billion from the IMF and some \$60 billion from other sources. The unprecedented shortfalls in foreign exchange reserves meant that the rescues had to be scaled in terms of the stock of private assets that might be moved, not annual flows.

Once a country has been hit by a currency crisis, any decent economist can find fault with its domestic economic policies. But any errors in Asian economic policy pale beside the magnitude of the currency collapse. The Asian countries all had relatively strong fiscal positions, low inflation, and high growth rates. Several had surprisingly large current account deficits, but such deficits are usually regarded as tolerable if the funds flow through to capital formation (as in Asia) rather than consumption (as in Mexico). Nor were real exchange rates seriously overvalued on a trade-weighted basis. In most cases, the current account deficits were "caused" by a surge of foreign capital inflows rather than by excessive domestic spending drawing in capital. Overall indebtedness was moderate relative to both GDP and exports; and concerns over basic solvency seemed to play no major role in the crisis.

The fundamental issue in Asia was liquidity, not solvency. Asia's problem was twofold: its debt was concentrated in short-term liabilities and its reserve assets were low. In Korea, for example, foreign indebtedness was relatively moderate, but large portions of the private debt were short-term loans. At the beginning of 1997, Korea's reserves were less than half its short-term liabilities, and a large portion of apparent reserves was committed to other purposes.

THE ROLE OF FINANCE

The emerging Asian economies have favored banks over security markets for financial intermediation. Little or no public debt exists to be traded, and businesses rely on bank loans rather than bond or equity issues for new capital.

The disruption of Asian currency markets was not preceded by widespread bank runs, but the economies hurt most by the crisis had long histories of problems with their banking systems and were in the midst of financial reform and liberalization as part of the move to full capital mobility. But liberalization also creates opportunities for excessive risk taking by inexperienced bankers supervised by inexperienced regulators. Even in the absence of crisis, a weak banking system is likely to limit the central bank's ability to raise interest rates to defend the currency. And Asian interest rate increases were surprisingly modest compared with earlier crises in other countries: central bankers put up only a limited battle before allowing their currencies to depreciate.

But the crises cannot be blamed on weak Asian banks. Many other countries with equally weak systems had no crisis. And the long-standing flaws in Asia's banking systems had not impeded development of its economies. In fact, Asia's system of financial intermediation was seen as one cause of its rapid economic growth.

Generating a crisis as dramatic as Asia's requires combining weaknesses in the domestic financial system with an effort to open it to international capital. In recent years, financial capital has been pouring into Asia. Foreign direct investment was heavily allocated to China, but much of the inflow elsewhere was in portfolio capital and bank loans. Before 1990, flows of portfolio capital were trivial, but by 1996 they exceeded \$30 billion a year, with half going to Korea. Outstanding bank loans to Asia increased from \$110 billion at the end of 1990 to \$367 billion at the end of 1996. When total loans peaked at \$390 billion in mid-1997, two-thirds had a maturity of a year or less.

LESSONS FROM THE PAST

Asian countries are not the first to liberalize their financial systems and link them to world markets. Many others have tried it and failed—an experience that offers several lessons. First, pursuing capital mobility before establishing a sound domestic financial system is dangerous. That is particularly true if domestic interest rates far exceed those in global markets, tempting domestic banks to borrow abroad and lend at home without the requisite skills and markets to manage currency risks. It is even more true if government commitments to fixed exchange rates lead participants to underestimate the currency risks.

Second, financial liberalization often outpaces improvements in the domestic regulatory system. Financial liberalization requires a profound change in the behavior of both banks and regulators. In a repressed market, government often uses banks as a tool of industrial policy. After liberalization, it must develop a supervisory function directed more toward discouraging excessive risk taking and rent-seeking behavior. In the short run, financial liberalization often has the perverse effect of raising domestic interest rates, and liberalization and increased competition push some firms and institutions toward bankruptcy. Without strong regulatory supervision, troubled banks will raise deposit rates and borrow to bet on one last roll of the dice. The deposit rate competition, in turn, draws in otherwise healthy banks. Once a bank is seriously impaired by its customers' losses, it compounds the problem by rolling old bad loans over into new loans to hide its own insolvency. Matters are even worse in countries that allow interlocking ownership of banks and business enterprises.

Third, regulators cannot be the only line of defense. Stronger accounting and public reporting requirements, together with standards for internal governance, are also essential to promote effective risk evaluation and management control by private individuals and markets.

Currency crises tied to banking failures typically have severe economywide effects. During the Latin American debt crisis of the early 1980s, Argentina's real exchange rate fell 50 percent and output declined 10 percent. In Chile the real exchange rate fell by a fourth, and output shrank by 15 percent. When Chile assumed private foreign debts and recapitalized the banking system, it raised public debt by about 30 percent of GDP.

In Mexico in 1994, the problems were not confined to the banking system. The government had financed much of its public debt with short-term marketable securities. When domestic

financial markets were opened to foreign investors, asset prices surged: inflation-adjusted equity market prices rose more than fivefold between 1988 and the end of 1993. Like the Asian economies, Mexico was caught with an imbalance of reserves relative to short-term foreign liabilities, and the resulting currency crisis and high domestic interest rates created severe domestic banking failures. A \$29 billion inflow of portfolio capital in 1993 reversed to a \$10 billion outflow in 1995. Output fell 6 percent in 1995, but growth recovered to average 6 percent a year in 1996–97. To date, Mexico has spent about 15 percent of its GDP recapitalizing the banking system.

RESPONSE TO THE ASIAN CRISIS

Just as a healthy bank needs an immediate source of liquidity to meet depositor demands for currency in a bank run, the immediate challenge for Asia, as for Mexico, was getting the resources to prevent a liquidity problem from turning into a solvency concern. But, though the response in Mexico eased the problem, the response in Asia exacerbated it.

Countries can respond to a currency crisis by a combination of raising domestic interest rates, selling foreign currency reserves, and devaluing the currency. Having seriously miscalculated their reserve needs relative to their short-term liabilities, the Asian economies seemed unwilling to raise interest rates for fear of wreaking havoc on a highly debt-leveraged financial system. Because of the stage of their liberalization programs, they also lacked the liquid short-term debt markets toward which stabilizing speculative inflows could have been directed. With most foreign liabilities denominated in foreign currencies, devaluation greatly increased the debt burden and raised concerns about solvency where none had existed.

The distinction between liquidity and solvency is particularly important for the IMF. In past debt crises, IMF involvement provided a seal of approval for debtor programs, assuring that creditors would be repaid. Periodic withdrawals under a stand-by credit agreement ensured continued compliance with IMF conditions. But in a liquidity crisis, when the aim is to eliminate the rationale for a run on a currency, staged conditionality can be self-defeating.

In Mexico, the IMF, the United States, and others provided the short-term financing required for a liquidity crisis. Needed funds were made available quickly and without significant conditions. As a result, Mexico required only \$30 billion of the \$52 billion package to stem the outflow during the first part of 1995. By mid-year it had begun repaying the U.S. loan, which was paid off completely early last year. The IMF loan will largely be repaid by 2000.

In Asia, IMF financing was stretched out over several years and strongly conditioned on structural reforms. Lacking the funds to address the liquidity concerns, the Asian economies had to let exchange rates fall to restore a balance of supply and demand for their currencies—and thus turned a liquidity crisis into a solvency problem.

The most immediate impact of a financial crisis is a sharp fall in domestic demand. Yet the IMF insisted that Asia's governments tighten fiscal policy and raise interest rates to attract foreign

finance, thus worsening the shock to domestic demand. A crisis limited to one country, as in Mexico, might have been amenable to increased exports and reduced imports to promote recovery; but a regionwide crisis makes such a solution next to impossible. Asia must rely more heavily on expanding domestic demand.

The Asian currency crisis will have its most severe demand-reducing effects on the banking system. But much of the banks' foreign borrowing was re-lent at home in dollars, and some of the foreign currency borrowing was undertaken by nonfinancial enterprises. Thus, sharply higher debt costs are not restricted to the banking system, and the problems of nonperforming loans and getting new loans are worsening.

Devising policies to ease the crisis in loan markets is tricky. Enterprises will be hard pressed to manage the higher interest rates on their existing debt, and insolvent enterprises must be liquidated or merged quickly. But the measure of insolvency depends greatly on the presumed future value of the exchange rate and interest rates. If rates move back toward pre-crisis levels, some now-insolvent firms will be viable. It is reasonable to provide some form of bridge financing for them, while adhering to a firm policy of liquidation for the deeply insolvent.

Any restructuring program must also restore both solvency and profitability to the banking system—a most difficult and costly task of recovery. Not only must governments integrate short-term programs of fiscal support and recapitalization, they must also restructure and reform the financial system. Prudential standards must be tightened and greater provisioning made for impaired loans, but both will increase the apparent capital shortfall. The central bank will also come under strong pressures to expand liquidity through loans and reduced reserve requirements at a time when it is hard to distinguish between solvent and insolvent banks. Costly as it is, however, a comprehensive plan to resolve the banking problems must be put into place quickly. Otherwise, private agents simply wait for more favorable terms from the government.

HASTE MAKES WASTE

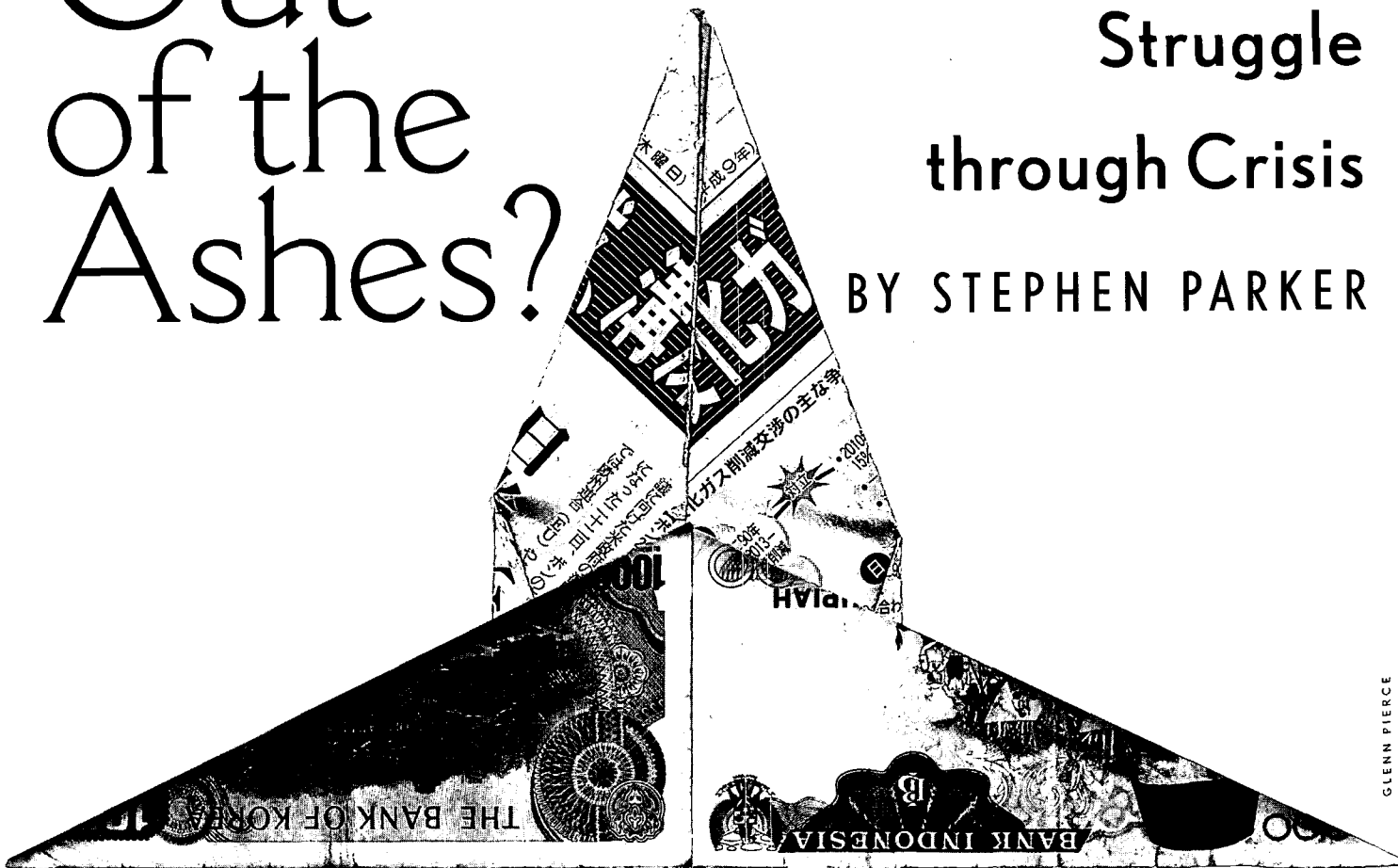
The crises in Asia highlight the dangers in the current expansion of the international financial system. Allowing financial capital to flow freely across national borders exposes countries to the inevitable risks of runs against their currencies, just as individual banks are threatened with runs domestically. Yet the international community does not appear willing to provide the funds to support an effective global lender of last resort. Developing countries will have to manage the risks of capital market opening knowing that they will be forced to rely primarily on their own resources in the event of a crisis.

Emerging markets should still aim for integration with the global financial system, but they must give themselves time to build the infrastructure to support that goal. They should give a high priority to financial system reform, while also actively discouraging short-term capital inflows and carefully monitoring the foreign currency exposure of domestic economic agents. Full capital mobility is the last stage in a complex process of financial liberalization and growth. ■

Out of the Ashes?

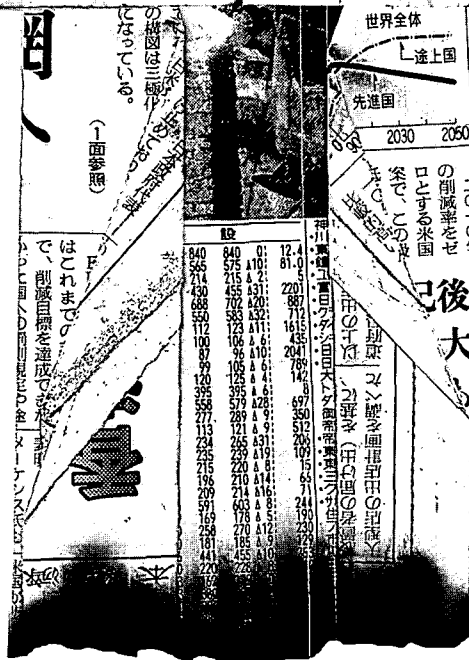
Southeast Asia's Struggle through Crisis

BY STEPHEN PARKER



GLENN PIERCE

The Southeast Asian countries of Thailand, Indonesia, Malaysia, the Philippines, and Singapore have been at the epicenter of the Asian economic crisis. On July 2 last year Thailand floated its baht after months of trying to defend it against market pressures. The baht sank immediately by about a third, followed with surprising speed by similar devaluations by the Philippines, Malaysia, and Indonesia. Even the Singapore dollar soon fell, though considerably less than the other currencies, and pressure on currency values spread to Northeast Asia, eventually to wreak havoc in South Korea by December.



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What started as a seemingly innocuous balance-of-payments problem degenerated into a full-scale economic, political, and social crisis that continues today. The breadth and depth of impact has surprised analysts through each stage of the crisis.

In its wake has come political change, economic recession, unprecedented unemployment, surging inflation, and collapsing imports throughout Southeast Asia. To regain stability and confidence, Thailand's democracy changed government leadership in November and shortly after rewrote the constitution to increase government accountability and transparency. Although the Thai baht has strengthened in recent months, the realization of the extent of the economic downturn becomes more sobering with each government report, the latest predicting a recession with output falling about 6 percent for 1998.

As of this writing, Indonesia stands on the brink of systematic collapse, with the resignation of President Suharto after 32 years of leadership of the New Order Regime and the prospect of declines in output of 20–30 percent. The nation is caught in a vicious cycle—with political transition requiring time but with economic collapse adding instability.

The economic fallout on Malaysia, the Philippines, and Singapore has been less severe, largely because of their more limited foreign debt exposure. For these countries, economic growth is expected to decline by at least half, to 0–4 percent. Nevertheless, Malaysian Prime Minister Mahathir has agreed to dismantle the long-time core of his political strategy, the New Economic Policy, that provided preferences for Malay nationals relative to ethnic-Chinese nationals. The Philippines, in many ways the least affected country in Southeast Asia, faces concerns about populist President-elect Estrada's commitment to continue the successful economic reforms of the Ramos administration. Even Singapore, the most economically developed Southeast Asian country, with respected market and commercial law institutions, is struggling with lower growth and heavy financial exposure to the Indonesian debacle.

Out of this turmoil, however, one catches glimpses of a rejuvenated Southeast Asia with strengthened political and economic institutions. Although the current unraveling in Indonesia (and a weak Japanese economy) casts a pall of concern over the region, many economic forecasts expect the Southeast Asian economies to bottom out over the next six to nine months and to resume moderate economic growth in 1999. After a damaging period of reticence by governments early in the currency crisis, Thailand, Indonesia, Malaysia, and the Philippines are all now implementing a wide range of economic, regulatory, and legal policy reforms. Rather than reversing course and turning inward by increasing protection and fomenting nationalism, all have reconfirmed their commitment to outward-looking development strategies.

The complex, systematic nature of the crisis has revealed strengths and weaknesses—both economic and political—in Southeast Asia's development process. Each country, of course, is different in many ways, but each faces the challenge of adapting its distinctive domestic political and economic systems to the homogenizing forces of globalization. The rapid spread of the crisis from its core in Southeast Asia to the rest of East Asia and then to world markets emphasizes the worldwide integration of financial markets. It also reflects the inability of international and regional mechanisms to monitor and contain the contagion effects of mistakes by governments and the private sector.

What were the main causes of this crisis? What lessons does it offer? What are the implications for U.S. interests? A closer look at the evolution of the crisis yields some interesting insights.

ANATOMY OF THE CRISIS IN SOUTHEAST ASIA

Almost universally, Southeast Asians and the international community trumpeted the region's strong economic fundamentals and stable political systems leading up to, and even

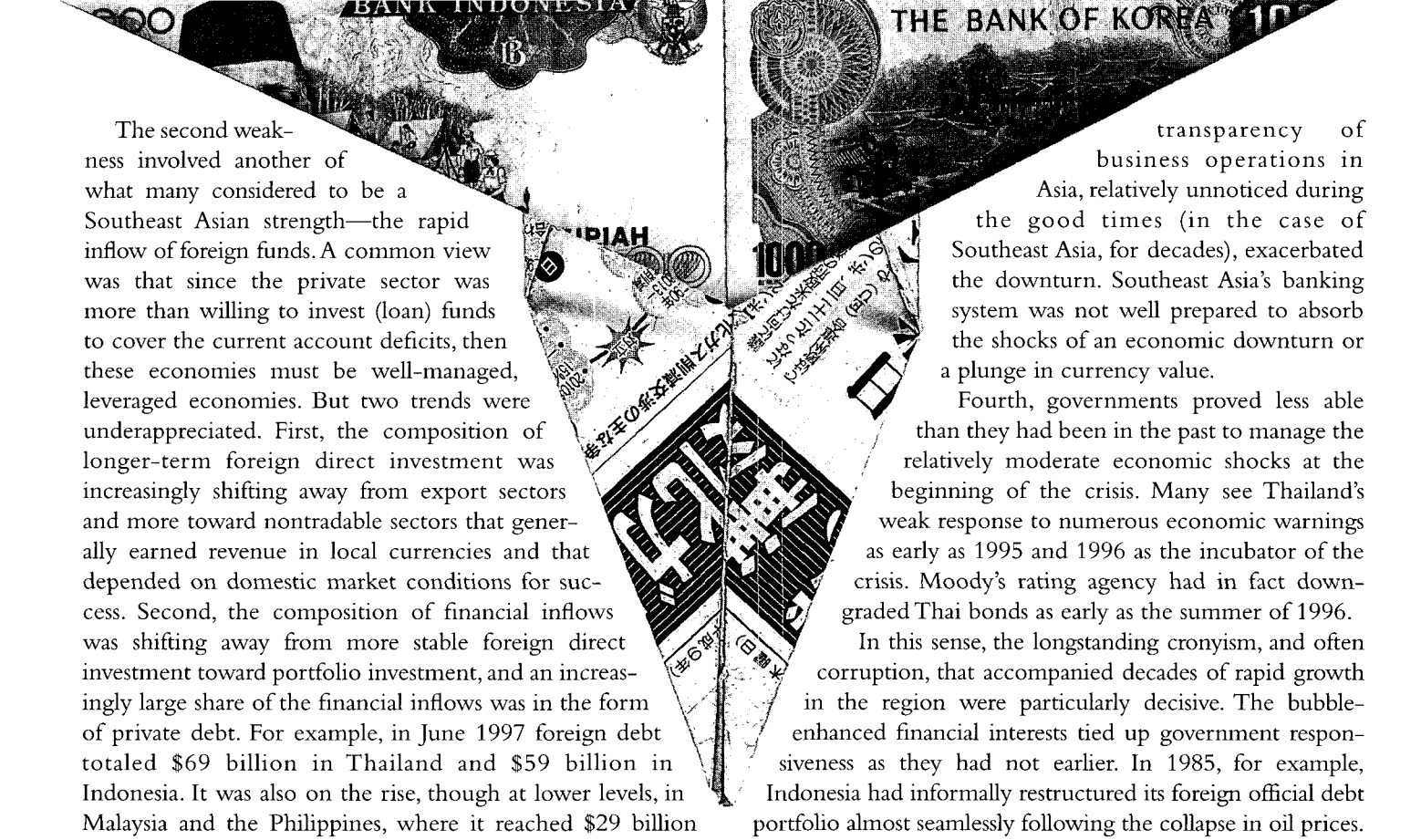
into, the initial stages of the crisis. After all, the Southeast Asian economies had grown in mass by close to 8 percent for decades, lifting tens of millions out of poverty and creating vibrant middle and upper classes. Southeast Asian governments and businesses had gained confidence and influence in regional and international affairs. In fact, however, the economic fundamentals were not as strong as projected in mid-1997, and they are not as weak now as they are presumed.

The region as a whole had been fighting a tendency to overheat since 1993–95. Characteristics of bubble economies were becoming increasingly apparent—prices on assets such as real estate and stock had skyrocketed; imports were growing rapidly while export growth lagged, resulting in substantial current account deficits. These deficits were financed by large inflows of foreign capital, which in turn exerted pressure to keep currency values high. Nominal currency values in the region had remained relatively stable for years, while real rates had appreciated significantly against the U.S. dollar (and even more so against the Japanese yen), lending a sense of security to investors that led many to resist spending the additional amounts needed to hedge their investments as a precaution against currency devaluation. Rapid growth and wealth generation created political environments where vested interests became increasingly virile, while East Asia's vaunted capacity to grow and to improve income distribution came into increasing question. Inflation, on the other hand, had generally declined in 1995 and 1996, reflecting conservative monetary and fiscal policies and the strong currency values.

SIGNS OF TROUBLE

Four understated weaknesses in the Southeast Asian economies stand out. First, although poorly researched even now, these economies (as did East Asia as a whole) appear to have been losing global competitiveness for at least the past several years. Their dramatic decades-long growth had depended on export growth typically in the 20–40 percent range. Most telling was the collapse in export growth between the summer of 1995 and the summer of 1996 in China, Korea, and Japan, as well as Thailand, Singapore, and the rest of Southeast Asia. Although exports rebounded a bit in 1997, they had not regained their earlier strength.

In addition, much of the region's rapid export growth in the 1990s was due to declining trade and investment barriers that encouraged greater trade in intermediate inputs among multinational production networks that now flourish in Asian economies. Although this encouraged efficiencies in production, it probably overstated growth in regional export value added. Southeast Asian firms had saturated many of their traditional export sectors such as clothing, footwear, and household electronics. They were facing increasing competition from other low-wage producers, while finding it hard to expand into new, more sophisticated export sectors. At the same time, trade liberalization, strong currencies, and rising domestic demand spurred growth in imports, which combined with weaker export growth to generate the high current account deficits.



The second weakness involved another of what many considered to be a Southeast Asian strength—the rapid inflow of foreign funds. A common view was that since the private sector was more than willing to invest (loan) funds to cover the current account deficits, then these economies must be well-managed, leveraged economies. But two trends were underappreciated. First, the composition of longer-term foreign direct investment was increasingly shifting away from export sectors and more toward nontradable sectors that generally earned revenue in local currencies and that depended on domestic market conditions for success. Second, the composition of financial inflows was shifting away from more stable foreign direct investment toward portfolio investment, and an increasingly large share of the financial inflows was in the form of private debt. For example, in June 1997 foreign debt totaled \$69 billion in Thailand and \$59 billion in Indonesia. It was also on the rise, though at lower levels, in Malaysia and the Philippines, where it reached \$29 billion and \$14 billion, respectively.

With interest rates on local debt about twice those on foreign debt, local banks borrowed overseas to cover lending to local business, and corporations borrowed directly from overseas sources. And, as has always been the case in Asia, most of this private debt was relatively short-term, predominantly less than 18 months, though it was often used to finance long-term projects that would require several rollovers to complete the financing cycle. Short-term private debt thus mounted without government authorities or private markets knowing its full extent. The region, especially Indonesia and Thailand, grew increasingly vulnerable to a shock to exchange rates since more and more overseas debt was used to earn revenue in local currency, but had to be paid back in foreign currency.

Third, the efficient use of private debt depends greatly on the effectiveness of an economy's financial intermediation system, which in Southeast Asia is concentrated in bank operations. Bubble economies place considerable stress on banking systems even in developed economies, as the costly U.S. savings and loan crisis did in the 1980s and as the ongoing and even more costly Japanese banking debacle is doing today. The situation is often even worse in developing economies, where regulatory environments are less strictly enforced, vested interests sometimes use preferential access to fund risky investments, and banks are not as skilled at differentiating the risk of investments. Worse still, some Asian banks tend to lend funds based on the asset values of their customers rather than on careful analysis of the cash flow returns of a particular investment. Thus the Asian banks increased their investment while asset values were high, and then, when asset values collapsed, drew back their loans more than necessary. The general lack of

transparency of business operations in Asia, relatively unnoticed during the good times (in the case of Southeast Asia, for decades), exacerbated the downturn. Southeast Asia's banking system was not well prepared to absorb the shocks of an economic downturn or a plunge in currency value.

Fourth, governments proved less able than they had been in the past to manage the relatively moderate economic shocks at the beginning of the crisis. Many see Thailand's weak response to numerous economic warnings as early as 1995 and 1996 as the incubator of the crisis. Moody's rating agency had in fact downgraded Thai bonds as early as the summer of 1996.

In this sense, the longstanding cronyism, and often corruption, that accompanied decades of rapid growth in the region were particularly decisive. The bubble-enhanced financial interests tied up government responsiveness as they had not earlier. In 1985, for example, Indonesia had informally restructured its foreign official debt portfolio almost seamlessly following the collapse in oil prices. Technocratic reformers in Thailand and Indonesia, who had traditionally been called in to resolve economic difficulties, actually favored bringing in the IMF to counterbalance the domestic political interests of the status quo who were blocking reform.

One reason for the limited success of the first IMF agreements in Indonesia and Thailand was the IMF's presumption that the technocrats would be given political authority, as they had been in the past, to implement the relatively mild policy changes initially required and to manage the financial restructuring to deal with the still underestimated private debt exposure. When political forces did not pass the torch to the technocrats and instead blocked meaningful change, governments and the IMF lost critical credibility in both domestic and international markets. As a result, they also lost the opportunity to buy time for serious financial restructuring and for distributing the costs of successfully rescheduling the predominantly short-term private foreign debt.

GLOBALISM VERSUS POLITICAL TRADITION

At the heart of the crisis is a fundamental tension over how governments harness the commercial windfall of globalism while managing the domestic economic, political, and social stresses caused by increased influences from abroad. As Southeast Asia moved toward modern, liberalized financial systems and open international capital markets, its domestic political and economic environment remained characterized by government preferences and by weak government regulation of banks and private foreign borrowing. The combination made the region far more vulnerable to exchange rate risk and balance-of-payments pressures.

The crisis sneaked up on the region in the guise of seemingly benign increases in private capital flows, further disguised by poorly reported statistics. In the end, however, it exposed the weaknesses, in a globalizing market environment, of domestic political systems that depend on traditional, personalized control and manipulation of powerful elite groups rather than on strong, independent institutions and legal systems.

LESSONS AND IMPLICATIONS OF THE CRISIS

The crisis in Southeast Asia proved much more serious than anyone would have imagined, both because of its systematic economic and political nature and because of the unforgiving makeup and magnitude of short-term, private foreign debt. Lessons abound.

Governments and the private sector in Southeast Asia must develop economic and political environments to regain capital, both domestic and foreign. The situation, however, is much different than it was during the capital booms of the 1980s and early 1990s, when intra-Asian capital flows were dominant. With the economic downturns in Japan, Korea, Hong Kong and Singapore, Asian sources of capital are limited. U.S. funds are thus likely to become more prominent in the region, even though they tend to have more strings attached, especially regarding demands for greater corporate and government transparency and more reliable legal systems. Market forces in this environment, therefore, are likely to reinforce IMF requirements to pressure for further reform.

As foreign firms move to merge and acquire Southeast Asian businesses, we already see clashes of corporate culture over managerial control and the difficulty of completing due diligence to determine the true financial circumstances of many Asian companies. These pressures, traumatic in nature for Asian economies, are likely to modernize economic and corporate governance and market institutions in Southeast Asia in ways that will strengthen their capacities in the future.

A key lesson of the crisis is that open private capital markets do indeed place considerable stress on domestic economic management and on political arrangements. Balancing monetary and exchange rate policy in small, open economies—no simple task at any time—is made particularly precarious if governments desire exchange rate stability and some independence in monetary policy. Similarly, private investors do indeed make mistakes, and governments do

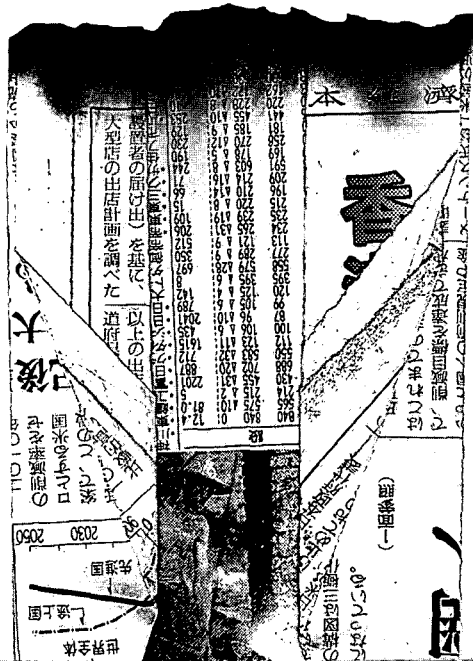
need to monitor and manage carefully private capital inflows. And lenders of last resort, such as the IMF, provide limited protection from government or private mistakes.

The crisis clearly calls into question what some Asians have called the "Asian Way," where economic development comes before political development, where business interactions tend to be personalized rather than supported by strong commercial law institutions, where business and the state operate in close quarters with limited independent regulatory oversight. Thailand's maturing democracy raises hopes that stronger political and economic institutions will emerge. Less politically open Singapore, in contrast, remains the bastion of solid market institutions and credibility. Indonesia's patriarchal autocracy proved incapable of balancing the need for distributing losses among domestic vested interests. The development of effective regulatory and commercial law systems is fundamentally a political decision, since independent institutions limit executive and preferential control over allocation of funds and power. There are real costs to maintaining domestic political conditions that limit the development of effective market institutions, especially for countries that rely importantly on foreign capital inflows and that are committed to global integration.

Implications for the United States are less direct. The crisis in Southeast Asia is having a relatively limited impact on U.S. commercial interests. U.S. banks were not heavily exposed to the Asian crisis economies, and U.S. trade interests with Southeast Asia are significant but not substantial. Once it became clear, with the successful negotiation in New York for the rollover of Korean debt in January, that the Asia crisis would not spill over into Japan and China, and thus would not likely pose a threat to the global economy, the U.S. stock market regained its upward momentum. In

fact, the crisis-related reforms enacted by the Southeast Asian governments should open access to U.S. investment and trade, especially in financial services, once regional economies stabilize and begin to grow again.

The decision by most of Southeast Asia's governments to continue on the track of outward-looking growth deflected what could have been the most serious ramification for U.S. policy—a withdrawal by the region into inward, nationalist governments playing off an anti-American backlash. The only remaining question mark is Indonesia, where political and social instability remain a major concern for U.S. strategic and political interests.

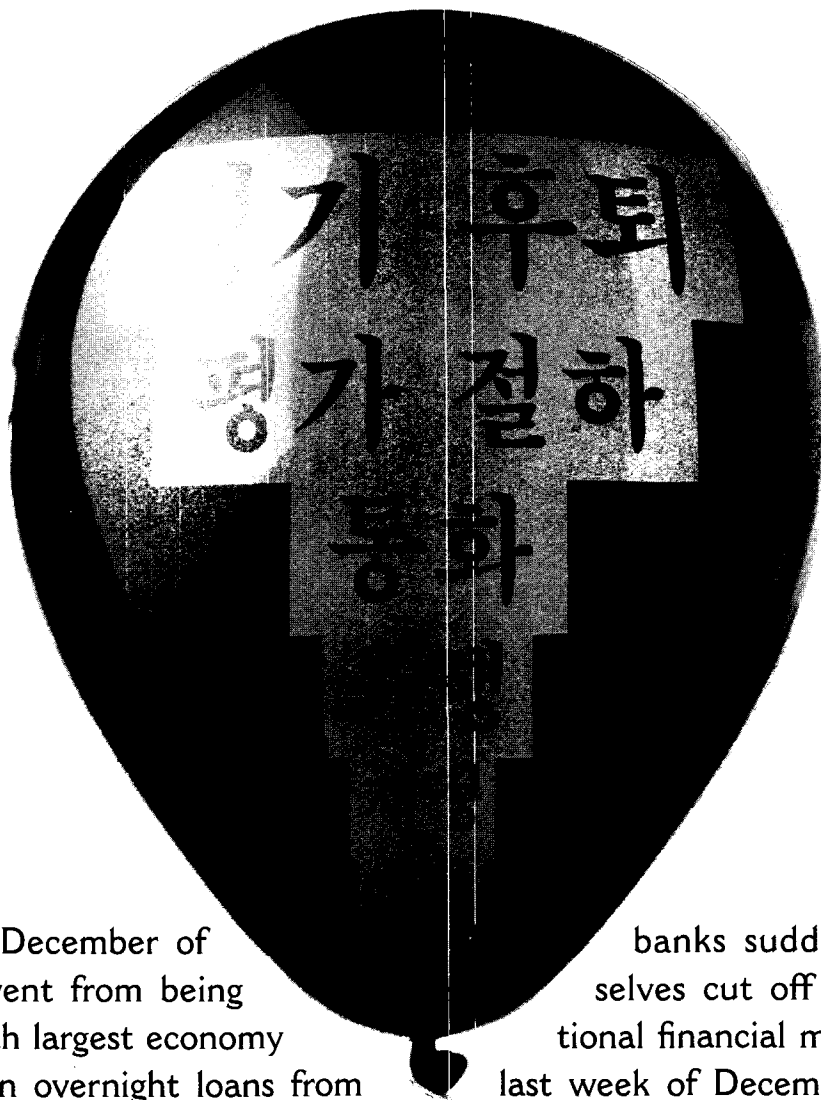


BANK INDONESIA

THE BANK OF KOREA

INVESTMENT BOOM

By
Yung
Chul
Park



Yung Chul Park is professor of economics at Korea University and president of the Korea Institute of Finance. This article was drawn from a longer paper presented at the conference on Coping with Financial Crises in Developing and Transition Countries, organized by FONDAD, the Hague, Netherlands, on March 16-17.

From October to December of last year, Korea went from being the world's eleventh largest economy to one surviving on overnight loans from the international money markets. Between November 19, when Korea decided to approach the International Monetary Fund for a rescue, and December 24, the won fell more than 50 percent against the U.S. dollar, the stock price index tumbled from 498 to 350, and the short-term market rate of interest shot up to 40 percent a year.

Although the IMF made a huge rescue package available on December 3, Korean

banks suddenly found themselves cut off from the international financial markets. During the last week of December, Korea was on the verge of defaulting on its foreign debts, a fate averted only by a last-minute emergency loan by the IMF and several G-7 countries.

Although Korean banks have been able to roll over some of their short-term debts and market sentiment seems once again to be turning in Korea's favor, Korea faces a long struggle in normalizing its ties to the international financial markets.

GLENN PIERCE

, FINANCIAL BUST

BUILDUP TO THE CRISIS: INVESTMENT BOOM

From 1995 to the beginning of 1997, Korea's economic growth averaged almost 8 percent a year, peaking in 1996 at nearly 9 percent. The growth was fueled by exports and also by high investment by Korean firms. And though investment seemed exactly the right prescription for an economy coming out of a mild 1992–93 contraction, in the end it contributed heavily to Korea's financial and foreign exchange crisis.

From late 1992 to mid-1995, the appreciation of the Japanese yen sharply increased the export earnings of Japan's East Asian trade competitors, especially Korea, and spurred investment throughout the region. In the third quarter of 1995, the yen began its long slide against the dollar, slowing not only Korea's exports but its economy as a whole. Korean policymakers made no substantial adjustments in the won-dollar exchange rate, and the real effective (trade-adjusted) exchange rate appreciated for more than a year and then remained relatively stable until the financial crisis broke out.

The investment boom, however, continued as foreign capital surged into Korea with the easing of capital controls as part of a general financial opening. With domestic interest rates more than twice those in world financial markets, net foreign capital inflows during 1994–96 reached \$52.3 billion, more than triple those for 1991–93. Much of the inflows, consisting of short-term liabilities of domestic financial institutions and firms, financed investment in Korea's major export-oriented industries: electronics, automobiles, iron and steel, shipbuilding, and petrochemicals. Investment jumped to 38.2 percent of GDP in 1996 from about 35 percent in 1993.

Although the economy began to slow in the second half of 1996, the large industrial groups, or chaebols, habituated to competing for market share rather than for profits, were

slow to adjust their production and investment. As inventories piled up, commercial banks became increasingly concerned about the chaebols' growing losses and accumulating debts and grew more selective in extending credit. Denied sufficient credit at commercial banks, the chaebols had to secure high-cost, short-term loans from merchant banks. They also turned to foreign financial institutions and markets to finance fixed investment as well as inventories. Foreign debts of domestic firms grew from \$35.6 billion at the end of 1996 to \$43.2 billion a year later. The liabilities of the foreign subsidiaries and branches of Korean firms were estimated to be more than \$51 billion at the end of June 1997.

The chaebols, almost all family-owned and reluctant to issue equities for fear of diluting their management control, relied ever more heavily on borrowing. The average debt-equity ratio of the 30 largest chaebols was more than 380 percent in 1996, four times that of Taiwanese industry. The rapid corporate debt accumulation proved the Korean economy's greatest structural weakness.

BUILDUP TO THE CRISIS: FINANCIAL OPENING

Until the end of the 1980s, capital movements into and out of Korea had been tightly regulated to facilitate the government's industrial policy and minimize the destabilizing effects of short-term capital flows on the economy. But by the 1990s, the effectiveness of the interventionist regime had come into question within Korea, and the developed countries, led by the United States, were pressuring Korea to liberalize its financial sector. Financial market deregulation and market opening began in earnest in 1993 when a new government came to power.

Like many other financial market openings in emerging market economies, Korea's experience demonstrates that an improperly managed opening can easily lead to a boom-and-bust cycle during the transition. The opening in Korea drew in a surge of

foreign capital, much of it short-term and speculative. As financial liberalization accelerated, domestic financial institutions were given greater freedom to manage their assets and liabilities, in particular to borrow from world financial markets. Korean financial institutions took imprudent risks investing in foreign securities with borrowed short-term funds, thus leaving Korea's economy vulnerable to the speculative currency attack and liquidity crisis that beset East Asia.

Korea's financial institutions had no expertise in credit analysis, risk management, and due diligence. They also had little experience in foreign exchange and securities trading and international banking in general. Nor did the supervisory authorities, pressured to overhaul the regulatory system to make it more compatible with a liberalized system, monitor international financial activities as they should have. They eliminated and relaxed many controls, but failed to replace them with a new system of prudential regulation to safeguard the stability and soundness of financial institutions.

Total capital flows (in and out) rose from less than 30 percent of GDP during 1991–93 to 47 percent during 1994–96. Of net inflows amounting to \$52.3 billion, 62 percent were short-term borrowings with maturities of less than one year. Although foreigners' equity investments increased somewhat, the biggest increases were in trade credit (more than sevenfold), bank borrowings (elevenfold), and borrowing of Korean branches of foreign banks from their home offices (more than sevenfold). The share of commercial banks' external short-term indebtedness in total external liabilities jumped to 79 percent in 1994 from less than 65 percent in 1993.

The supervisory authorities did nothing to correct the prevalence of short-term external financing. Nurtured in the tradition of direct control, they had neither the resources nor the experience to maintain the overall soundness and profitability of financial institutions. Long relegated to the role of supporting manufacturing industries under the control of the government, banks and other financial institutions had become accustomed to accommodating the credit needs of the industrial conglomerates without necessarily checking their creditworthiness.

THE CRISIS IN FULL FORCE

The investment boom supported by foreign credit could not last long, and the government was powerless to come to the rescue when corporate bankruptcies began to soar, along with the volume of nonperforming loans at financial institutions.

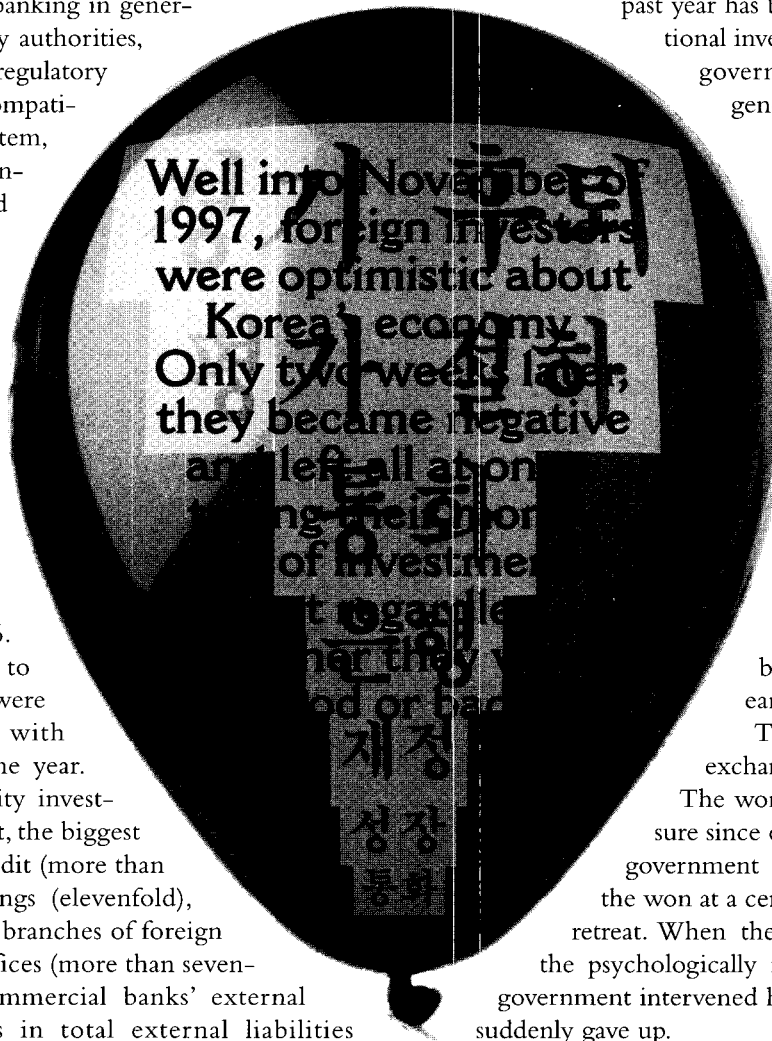
The first major casualty was the Hanbo group. The nation's fourteenth largest chaebol was placed in court receivership early in 1997. A subsequent investigation revealed ties between politicians and the iron and steel group on a scale that shocked the Korean people and foreign investors alike. Indeed, the pervasiveness of corruption discovered in Korea this past year has been central to foreign institutional investors' loss of confidence in the government and the economy in general.

By the first week of September six chaebols, including the Kia Group, the nation's eighth largest, had been placed under a workout plan or become insolvent. The government, having lost the confidence of the public, became a lame duck. With the next presidential election scheduled in December, the administration was powerless to restore stability to financial markets. Foreign investors began withdrawing funds in early September.

The government's handling of exchange rate policy did not help. The won had been under strong pressure since early 1997. Time after time the government declared its intent to defend the won at a certain level, only to be forced to retreat. When the won-dollar rate approached the psychologically important level of 1,000, the government intervened heavily in the market and then suddenly gave up.

Between June and November, the Bank of Korea's reserve holdings fell by \$10 billion, and it sold \$12.2 billion in the spot market and made forward sales amounting to \$7 billion to defend the won. By the end of November the bank held \$7 billion in usable reserves.

Toward the end of October, policymakers and market participants alike realized that the situation was getting out of control. Foreign investors fled the stock market, and Korean banks were increasingly unable to roll over their short-term financial loans. To avoid default they turned to the Bank of Korea for liquidity or resorted to the foreign overnight loan markets. Finally, on November 19, the government announced reforms regarding nonperforming loans; it also



widened the exchange rate fluctuation band. But with the sense of panic rising by the day, the market hardly noticed.

On November 23, the government announced its decision to approach the IMF. Ten days later, the IMF agreed to provide \$21 billion over three years. It also secured commitments totaling \$36 billion from the World Bank, the Asian Development Bank, the United States, and 12 other countries as a second line of defense. In return the IMF required reforms often linked with such rescue packages—tight money policy, a fiscal surplus, sweeping financial reform, and further liberalization of the financial markets. It also demanded more flexible labor markets and restructuring of the chaebols.

The rescue, however, did little to allay fears and stabilize the financial markets. Many observers doubted that Korea would be able to comply with the structural reforms mandated by the IMF. They feared that the tight monetary and fiscal policies would depress economic activity and undermine Korea's ability to service its foreign debt, thus defeating the purpose of the IMF. The rollover rate at commercial rates fell to about 10 percent, market interest rates shot up to 40 percent, and the won continued to fall, reaching 1,995 to the dollar on December 23.

As rumors began to circulate among foreign investors that Korea might have to declare a debt moratorium, on Christmas Eve the IMF and the G-7 countries came up with a \$10 billion emergency financing program, drawing \$8 billion from the second line of defense. The new package turned market sentiment around by demonstrating the resolve of the IMF and G-7 to rescue Korea. It represented a new watershed, with the IMF clearly serving as lender of last resort in the East Asian financial crisis.

CONTAGION

Despite the numerous mistakes made by Korean policymakers, regulators, bankers, and businesses, Korea's economic fundamentals were sound. In many respects Korea looked quite different from the other Southeast Asian economies experiencing crisis in 1997. During 1991–96 it ran a budget surplus. Monetary expansion was moderate. The savings rate was one of the highest in the world. Capital inflows, which totaled no more than 2.7 percent of GDP, were primarily channeled to the nonmanufacturing sector for its fixed investments.

What suddenly gave foreign investors such grave doubts about the prospects of the Korean economy? Journalistic accounts suggest that these investors, increasingly concerned about structural weaknesses that made Korea highly risky for portfolio investment and bank lending, finally got fed up and left. Certainly, foreign investors had long complained of the lack of transparency in corporate management in Korea, questioned the reliability of balance sheets and income statements of large corporations and banks, and warned of the risks in the cross-ownership and cross-debt guarantees between the affiliates of Korea's major conglomerates.

But these problems had never made them contemplate a sudden withdrawal from Korea before Southeast Asia's currency crisis erupted. In fact, well into November, according to a survey by the Korea Development Institute, many foreign investors were "optimistic" about the future of Korea's econo-

my. Only two weeks later would they become negative and leave all at once, taking their money out of investments almost regardless of whether they were good or bad.

It appears that Korea was affected by the contagion of the Southeast Asian crisis. In particular, the Hong Kong stock market crash in the third week of October helped trigger the exodus of foreign banks and institutional investors from Korea. Before July 1997, changes in the Hong Kong stock index had little effect on movements of Korea's index. Afterward, the two moved together, with the causal effects clearly running from Hong Kong to Korea.

After the Hong Kong crash, the Korean economy suddenly looked vulnerable to foreign investors, and a stampede ensued. The close presidential race in Korea, with the election scheduled for December, cast doubt as to the prospects for economic reform and accelerated the flight of foreign investors.

MANAGING FINANCIAL CRISES

Korea faces a difficult future. During 1998, fixed investment is expected to fall more than 30 percent, consumption 10 percent. Aggregate demand will likely fall more than 5 percent, despite an expected 7 percent rise in exports. Annual inflation will soar to about 10 percent, while the jobless rate will probably exceed 5 percent. Recent forecasts suggest that it will take Korea at least two years to recover.

The Korean government bears much responsibility for the Korean crisis. Policymakers tinkered with essential economic reforms for far too long, thereby deepening foreign investors' distrust. Furthermore, in 1997 they paid too little attention to the sharp deterioration in various liquidity indicators and to the complaints of foreign investors about secretive management of corporations and financial institutions or the reliability of the published statistics on banking and foreign reserve holdings. They also tried to defend the won for too long by maintaining a managed floating system, thereby costing the Bank of Korea substantial reserves.

At the same time, increasingly evident deficiencies of the international financial markets, including herd behavior and information problems on the part of investors, exacerbated the crisis and worsened its damage.

The East Asian crisis has shown that in an integrated financial world, financial crises can be contagious and pose systemic risk. But most of the measures proposed so far for preventing and better managing such crises—creating an international lender of last resort, restructuring the IMF for regulating global institutional investors, harmonizing rules and enforcement efforts at a regional or global level—are not likely to be realized any time soon. Given this reality, and in view of the severity of the ongoing financial crisis in East Asia, the international financial community should seriously reconsider the demands it is making on emerging market economies to open their financial markets. Until the international financial community is willing and able to safeguard these countries from the recurrence of devastating financial crises, it should be prepared to tolerate the sand they throw into the wheels of international finance. ■

SPUTTER, CHOKER

By Robert Alan Feldman

Hopes in Asia Pacific that Japan will help solve the region's financial crisis are all but certain to be dashed. Japan does not have the fiscal power and maneuverability to act as the engine of Asia. More important, it may not have the political will.

Since the equity and real estate bubble burst in 1990, Japan has abdicated the intellectual leadership of the region. By tinkering with and expanding—rather than junking—the state-capitalist economic model of the postwar period, Japan is offering a “wagons in a circle” example to Asian countries. Even if that strategy were right for Japan (which is doubtful), it is almost certainly not economically optimal for other Asian nations.

But economic optimality may not be driving either Japanese or Asian policy. If “Asian values,” rather than the conservatism of wealth, have been the determining factors behind Japan's torpid reform efforts of the 1990s, then the policy choices made by the Asian countries may not accord with Western logic. To the extent that Asian countries imitate the Japanese reform model, economic prospects for the region—and for the firms that operate there—could improve more slowly than now expected.

Robert Alan Feldman is chief economist for Japan at Morgan Stanley Dean Witter. The views expressed in this article are the author's and not necessarily those of Morgan Stanley Dean Witter.



COUGH,

Japan Misfires as the Engine of Asia



JON CONRAD

JAPAN'S ECONOMY: DOWN AGAIN IN 1998

The Japanese economy is now facing gale-force headwinds from private domestic demand. Fight as it may, the government's demand-support policies are unlikely to generate positive growth in 1998.

Business investment has already entered a downturn. Typically, such downturns last two to three years, and so far no sign of revival is visible. In addition to negative profit momentum, tighter credit standards imposed by banks are causing a credit crunch among small and medium-sized businesses. *Housing investment* is in just as serious shape. The effects of low interest rates and government housing programs have worn off, and the outlook for income growth is poor. Moreover, latest indications suggest that residential land prices are headed for another dive—hardly the time that households will rush to buy. *Inventories* relative to sales are at the highest level since 1975. The March decline of nearly 14 percent in overtime hours in manufacturing is a harbinger of a continued decline of production, income, and demand. Finally, the *export* outlook is cloudy. The drop of shipments to Asian economies, which make up about 40 percent of Japan's exports, will likely cut about 1 percent from Japanese GDP growth. Even the weakening of the yen against the dollar and European currencies and continued upswings in the United States and Europe will barely offset the losses to Asian destinations. (The net export contribution to growth may be positive—but only because Japanese imports are collapsing.)

Both fiscal and monetary policy are fighting against the downturn. Although the initial 1998 budget was contractionary, the stimulus package announced at end-April should generate a modest gain of public works spending during fiscal 1998. Moreover, the package's restoration of the 2 trillion yen of income tax cuts, which had been withdrawn in February 1997, should replace much of income lost to lower overtime and the squeeze on wages. In addition, the Bank of Japan is maintaining its low interest rate policy, and is providing huge quantities of credit through nonstandard routes as a means to offset the credit crunch.

These measures put a floor under the economy for 1998, but are not likely to spark sustainable growth.

PRICE AND NONPRICE COMPETITION

The yen, already weak against the dollar, is unlikely to strengthen and may weaken further, putting more downward pressure on the currencies of Asia against the dollar. That would exacerbate foreign debt problems in Asia, destabilize financial systems and corporate balance sheets further, and worsen and lengthen the Asian crisis. Certainly in the recent past, weakness in the yen against the dollar has been followed by Asian currency weakness. The yen's fall—to 132 yen to the dollar—in early 1998 coincided with the weakest point for many Asian currencies, and its subsequent rebound coincided with rebounds of some of the Asian currencies as well. At current exchange rates, many Japanese industries remain highly competitive.

Japan also remains strong relative to Asian countries in nonprice competitiveness. Product quality and innovation are high. Labor is expensive but high in quality and reliability. Distribution channels are well developed. Technology levels are high. And infrastructure in most areas is far

above the levels of Asian competitors—although not necessarily competitors from industrial countries.

In short, in both price (exchange rate) and nonprice factors, Japan remains highly competitive against Asian competitors.

INTELLECTUAL LEADERSHIP: JAPAN HAS ABDICATED

The most important way for Japan to influence the course of the Asian crisis is by example. Just as Japan's postwar success with an export-based, state-capitalist economy prompted developing Asian countries to follow that same model, Japan's reaction to the equity and land price collapses and banking problems of the 1990s promises to shape Asia's reaction to similar problems. Asian leaders feel more comfortable with Japanese than with Western social philosophy. Japanese economic policies are presumed more consistent with "Asian values" and thus more likely to work than Western solutions.

DEMAND MANAGEMENT POLICIES

Japan reacted to the problems of the 1990s in several stages. First, it tried aggressive demand-support policies by raising public spending and cutting taxes and interest rates. General government fiscal balance shifted from a surplus of 3 percent of GDP in 1991 to a deficit of more than 4 percent in 1996. The lesson was "when faced with a market crash and a banking crisis, the first thing to do is loosen fiscal and monetary policies."

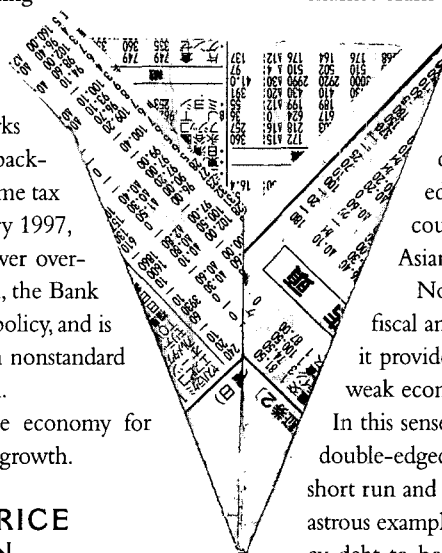
Japan could try that approach because its initial fiscal position was strong and real interest rates were high. It also had a huge excess of private savings over domestic investment and virtually no net debt denominated in foreign currencies. But conditions in other Asian countries (possibly excepting Taiwan) at the onset of the Asian financial crisis were totally different.

Now that Japan has run out of room for maneuver with both fiscal and monetary policy, what it does next will be the example it provides to Asia. If it tries to inflate its way out of a structurally weak economy, that would suggest to Asia that it try to do the same. In this sense, the fiscal package recently adopted in Japan would be a double-edged sword for Asia. It could support Japanese growth in the short run and hence the market for Asian exports, but it would be a disastrous example to countries already heavily indebted (in foreign currency debt to boot). The short-term gains to Asia from a year or two of Japanese growth could even be offset by long-term losses if Asia receives the wrong policy message.

PUBLIC-SECTOR REFORM

Japan also responded to the crises of the 1990s through public-sector reform to try to counter the tendency toward growth in government, in public-sector financial intermediation, and in special corporations. While helpful in earlier phases of growth, these institutions have led to inefficiencies that have been an important drag on growth in both Japan and Asia.

There have been two attempts at public-sector reform—under Prime Minister Murayama in 1994–95 and under Prime Minister Hashimoto in 1997—but both fell far short of hopes. Major privatizations and increases of accountability are yet to be implemented. A Hashimoto-led commission also proposed "administrative reform" to cut the number of



ministries from 22 to 12 and shift jurisdictions among ministries. But the wings of that reform were clipped by vested interests in industry, bureaucracy, and politics well before the proposals were drafted into legislation.

Despite private-sector complaints that the public financial system interferes with the private economy, steals business, and operates with unfair advantages, the public system continues to grow. The ratio of total assets of the Trust Fund Bureau (a Ministry of Finance bureau that invests funds of the Postal Savings Bank and Postal Life Insurance, public pension funds, and some other funds) to nominal GDP rose from 57 percent in 1990 to 81 percent in 1997. And recent proposals from the ruling LDP herald even larger lending by public institutions.

In short, Japan has not succeeded in reform of the public sector, despite a broad understanding of the problem, increasingly glaring inefficiencies, and a long series of scandals in a broad range of public-sector functions—hardly a good example for the rest of Asia.

FINANCIAL-SECTOR REFORM

The financial sector has also been a key focus of reform since 1991, when investors were shocked by even the first estimates of the extent of bad loans—20 trillion yen (about 4 percent of nominal GDP). Japan first tried a strategy of forbearance (not strictly forcing recognition and writeoff of bad loans) combined with demand stimulus in the hope that financial institutions would earn their way out of trouble. But the strategy failed, both because early estimates of bad assets were wildly low (recent estimates are many-fold greater than the initial estimates) and because growth was too weak to generate profits to write off the ballooning bad debts.

The focus of financial-sector support then shifted to tax relief. At a high cost in lost tax revenue, financial institutions were allowed to write off bad loans. Indeed, financial institutions were responsible for much of the plunge of corporate tax revenue from 19 trillion yen in fiscal 1989 to about 13 trillion yen in 1994–96. As estimates of bad debts continued to mount, depositors began shifting deposits out of the private system into the postal savings system.

Reform during 1994–96 also involved a quiet but clear improvement in the rules of financial oversight coupled with creation of a better safety net for depositors. The definition of nonperforming assets was tightened, and requirements for their disclosure were strengthened. The Deposit Insurance Corporation was mobilized to liquidate financial institutions; its resources were augmented by increased premiums on banks, and its scope for borrowing was enhanced. In addition, work was begun on better capital requirements for banks, and life insurance companies were subjected to “solvency ratios,” the equivalent of capital standards. But here too there has been backsliding, such as easing the accounting treatment of market assets to allow institutions to avoid declaring trading losses on bonds at book closing. Moreover, by mid-1996, it was clear that a true solution to the financial-sector problem was not in sight.

The third stage of financial-sector reform, announced with great fanfare in autumn 1996, was the Big Bang, a set of legal reforms encompassing a new central bank law, a new foreign exchange law, a new financial oversight agency law, a new holding company law, tightened accounting standards, increased cross-entry of financial firms into each others’ traditional business areas, and many other reforms. But the commitment to Big Bang reforms was sorely tested in 1997, when several major financial institutions underwent stress, including bankruptcies.

In the wake of these disruptions, the authorities have embarked on actions that have shaken investor confidence in their willingness to enforce efficiency in the financial sector. For example, they have declared their intent not to allow the exit of any more large banks. And the weak conditionality on the injection of public capital into institutions raised questions about how sharp the authorities’ teeth really are. Moreover these injections of public capital are more likely to prolong excess capacity, continue pressure on margins, and extend the caution of banks toward borrowers than to solve any of these problems.

In short, Japan’s signals to Asia regarding financial reform have been mixed. While pursuing a clear agenda of improving rules on competition, oversight, and accounting, policymakers seem to be trying to maintain the status quo within the new set of rules. Because the authorities are not willing to take the consequences of recognizing losses, potentially productive resources are being withheld from the economy. The eruption of new scandals, including multiple murders and suicides, has resulted in all-time low confidence in the financial system.

POLITICAL REFORM

The recession of 1991–93 knocked the LDP out of power for the first time since it was formed in 1957. In the year following the June 1993 general election, a motley coalition of old-line opposition parties and reformist LDP splinter groups managed to pass important political reforms. They eliminated multi-member election districts (2 to 6 members per district) in the Lower House of the Diet and replaced them with a combination of single-member districts and super-regional districts (with many seats allocated on the basis of party votes in the region). They reapportioned all districts to correct inequalities in the weight of votes between different parts of the country. And they strengthened campaign financing laws.

But the reforms have had little effect on economic policy. The LDP regained power in 1994 by forming a coalition with its former arch-rival, the Socialist Party, and in the run-up to the October 1996 general election, the LDP-led government favored such old economic chestnuts as public works spending and bigger subsidies for farmers. The usual coalitions of vested interests have also returned to blocking important deregulation items.

Voters, on balance, have validated the status quo. The fall in voter turnout in recent elections indicates a generalized antipathy toward the state of politics, but it does not alter the incentives felt by national political parties. For example, the 1996 general election virtually wiped out the Socialists and gave the LDP a near majority in the Lower House. And renegades from opposition parties have since joined the LDP, returning it to its past status.

Japanese voters seem to prefer familiar stagnation to the uncertainties of economic reform. Optimistic Western observers hope that the voters’ preference grows out of the relative wealth of the Japanese people and that it will not flourish in the poorer Asia-Pacific soil. But the Japanese election results may also stem from the part of Asian social philosophy that values social stability over growth. The Upper House election in July will be the next test of Japanese voter attitudes. Should voters again signal their preference for stability over growth, the lesson is not likely to be lost on leaders of Asia-Pacific nations. If Asian leaders act on that lesson, rather than in line with more aggressive reform models, hopes for rapid economic reform in the region would be clouded by the prospect of a more prolonged period of economic adjustment. ■

Dodging the Bullet —This Time

by David D. Hale



The Asian Crisis and U.S. Economic Growth during 1998

One of the great surprises of the U.S. economy this year has been its capacity to withstand the trade shocks resulting from the Asian financial crisis.

At the end of 1997, most economists were revising down their forecasts of U.S. output growth by 0.5–1.0 percentage point to adjust for the impact of the crisis on both imports and exports. As the United States sends about one-third of its exports to Asia and is the major market for the exports of Asian countries whose currencies have collapsed, the U.S. trade deficit had been widely expected to increase by about \$50–60 billion this year. Concern about export losses was especially great on the U.S. west coast, which depends far more heavily on Asian trade than other regions. Worries about tourism also flourished. Las Vegas bacarat tables, for example, suffered a 25 percent slump because of the loss of high rollers from the overseas Chinese communities of Southeast Asia.

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During the first quarter of this year the U.S. trade deficit widened by some 2 percent of real GDP. Exports to Indonesia, Thailand, and South Korea slumped by 37 percent during January and February while exports to Japan fell by 7.6 percent. But the trade deterioration did not dampen the U.S. economy's overall growth momentum because the growth rate of domestic final sales accelerated from 1.9 percent to 6.1 percent during the fourth quarter of 1997 and thus boosted the quarterly growth rate of total output from 3.7 percent to 4.2 percent.

WHAT IS DRIVING U.S. GROWTH?

Three factors explain why U.S. domestic spending has remained so robust in the face of trade shocks resulting from the Asia slump.

The first factor is the reduced risk of Federal Reserve tightening. With the U.S. economy growing so robustly last year and unemployment in decline, the Federal Reserve would likely have raised interest rates late last year or early this year had it not been so concerned about financial stability in East Asia. The passivity of U.S. monetary policy helped produce large gains in residential construction and commercial real estate. New home sales rose to the highest level in several years while the Dun and Bradstreet survey found a sharp upturn in business confidence in the construction industry.

The second factor is the resilience of the U.S. equity market. It rose to new highs during the first five months of this year because of investor optimism about interest rates and confidence that the Asian crisis had been contained. The poor performance of Asia's economies probably also boosted foreign demand for U.S. financial assets still further after two years of unprecedented growth in foreign purchases of U.S. bonds and equities. During 1997, foreign investors bought \$66 billion of U.S. equities and \$184 billion of Treasury securities, as against \$12.5 billion of equity and \$232 billion of government securities during 1996. The buoyancy of the U.S. equity market helped bolster household wealth and sent consumer spending rising at a 5.7 percent annual rate during the first quarter of 1998.

The strong capital positions and high profitability of American banks has also helped. According to annual report footnotes, America's leading money center banks have more than \$100 billion of exposure to Asia through a mixture of dollar loans, local currency loans, and security investments—nearly as much aggregate lending as went to Latin America during the debt crisis of the early 1980s. But with today's low interest rates and healthy profitability, U.S. banks are competing aggressively to make new loans despite losses in Asia.

The buoyancy of the stock market has become so great in relation to profit growth that market analysts are beginning to worry about the United States creating a "bubble economy." During 1991–97, equity market appreciation was driven equally by profit growth and appreciation of share price multiples. During the past six months, most of the gain in equi-



ty prices has come from multiple appreciation. Evidence is also increasing that the stock market boom is spilling over into real estate. House prices are rising sharply in several cities, and commercial construction appears poised for its biggest upturn since the late 1980s. The valuation parameters of U.S. equity and property markets are still far more modest than they were in Japan during the late 1980s, but public involvement in the U.S. equity market is unprecedented: about 45 percent of all American households now own equities. The mutual fund industry has grown to \$5 trillion and is now larger than the U.S. banking system. The Federal Reserve has been reluctant to raise interest rates to dampen the equity market, despite sharply declining unemployment, because of the persistence of low inflation and concern about Asia. Just as Japan created its bubble economy during the late 1980s in part because of monetary policy designed to protect the U.S. dollar, so could the United States now experience a period of speculative excess in domestic financial markets because of the need to help Asia.

The third factor helping to buoy U.S. growth this year has been the impact of the Asian slump on global commodity prices and U.S. import prices. Both have fallen across the board during recent months and thus helped boost consumer real income in the United States by lowering inflation. In fact, it increasingly appears that commodity-producing countries will bear the brunt of the Asian shock. During the past year the trade accounts of commodity-producing countries have deteriorated much more sharply as a result of the Asia crisis than those of industrial countries. Oil-exporting countries' trade balance has deteriorated by \$61.9 billion, as against only \$13 billion for North America. Latin America's trade balance has worsened by nearly \$19 billion because two-thirds of its exports still come from commodity-producing sectors. If OPEC reduces production, the price of oil could rise later this year, but other import prices are likely to remain depressed because of capacity gluts in Asia. The income gains in the United States resulting from the decline in nonoil import prices appear likely to be about 0.75 percent of GDP this year.

The resilience of the U.S. economy so far this year demonstrates the need to analyze carefully the impact of an economic shock on a country's capital account and terms of trade, not just its merchandise trade account. In fact, the whole history of the East Asia crisis has been one of economic pundits underestimating the role of the capital account. During the mid-1990s, the IMF had criticized some Asian countries, especially Thailand, for running large current account deficits and encouraged them to devalue. The countries were reluctant to devalue because their private sectors had accumulated large dollar liabilities and thus were vulnerable to an upsurge of bankruptcies if their exchange rates adjusted dramatically. The failure of the IMF and the credit rating agencies to understand

the role of Asia's capital account liberalization in the region's corporate development process explains why the Thai devaluation generated so much financial contagion. Once corporations in Southeast Asia saw Thailand violate its long-standing promise of exchange rate stability, they all rushed to hedge their dollar liabilities and generated a wave of selling that became uncontrollable. The exchange rates of Thailand, Indonesia, Malaysia, and other countries fell far more than could be justified by inflation rates, budget deficits, or even trade accounts.

The United States was far better poised to benefit from the Asia crisis than other countries because of the openness of its capital account and asset markets. With few barriers to foreign investment and both the largest and most liquid financial asset markets in the world, the United States is a natural receptacle for the world's surplus liquidity. In the 1980s the liquidity came from Japan.

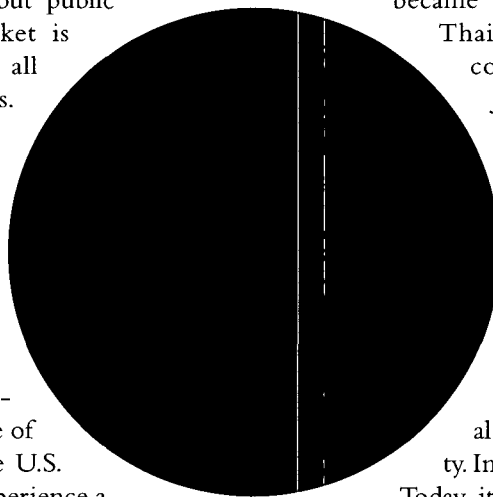
Today it is coming from practically everywhere because North America is the only region of the world with a large current account deficit. Japan and Europe have been running large surpluses for several years. The East Asian financial crisis is now forcing that region to move into surplus while the current account deficits of Latin America are far smaller today than they were during the early 1990s.

In the 1980s the United States ran a large current account deficit in part because of large federal budget deficits. Washington will soon be reporting a budget surplus close to \$100 billion. The reemergence of the United States as a large-scale capital importer has resulted purely from private-sector financial developments. The United States now enjoys far better investment opportunities than do other countries and thus can import capital on a large scale. As with East Asia, this trend could go too far and encourage speculative excesses in U.S. asset markets, but in 1998 the United States is still able to play the benign role of global spender of last resort.

AMERICA'S LEADERSHIP ROLE

The Asian crisis has reestablished America as the economic superpower in the region. The United States has been dominant in defining the response of the international community to the crisis. Though congressional restrictions made it unable to contribute directly to the Thailand IMF program in July 1997, the United States consulted extensively on the Thai situation through the IMF. When the congressional restrictions expired last September, Washington contributed directly to the IMF programs for Indonesia and Korea.

As a result of U.S. influence, the IMF has focused far more on microeconomic reform and trade liberalization in Asia than it did in Latin America during the 1980s. The Asian programs are modeled more after the IMF experience in Eastern Europe than the programs that preceded the end of



the Cold War. Deputy Treasury Secretary Lawrence Summers summarized matters at a recent conference of the Bretton Woods Committee by saying publicly, "The IMF has done more to promote America's trade and investment agenda in East Asia than 30 years of bilateral trade negotiations."

America's decision to use the IMF to promote microeconomic reform could backfire by arousing nationalist sentiment against the IMF and the West in general. But so far the policy has worked. The Asian countries have responded to the crisis by further financial liberalization and by dismantling barriers to investment. There has been no retreat into a siege economy.

If the microeconomic liberalization policies can be sustained, the current crisis could actually accelerate East Asia's transition both to truly open markets and to the Anglo-Saxon form of capitalism. In Korea, for example, foreign trade could expand both because of reduced barriers to imports and because of increased foreign direct investment. Like Japan, Korea has long restricted foreign investment and now has only about \$12.5 billion—as against \$67 billion in Singapore, \$42 billion in Malaysia, \$72 billion in Mexico, and \$20 billion in Thailand. Because multinational corporations are so important in generating both exports and imports, low foreign investment in Korea and Japan has long been viewed as a de facto trade barrier. IMF programs that enhance foreign access to Korean asset markets should therefore boost trade as well.

When the Asia crisis began, Washington probably did not foresee how crucial its own role would become. Most pundits expected Japan, a large investor and bank lender in East Asia over the past decade, to emerge as a key regional leader. Japan did contribute more financially to the IMF programs than any other country (\$18.5 billion, as against \$8 billion for the United States), and it did propose establishing a regional monetary fund to complement the resources of the IMF. But Japan's credibility was greatly undermined by its own economic stagnation and banking crisis. As the crisis unfolded, Asian countries turned increasingly to the United States for help while the U.S. Treasury itself rejected Japan's proposals for a regional monetary fund.

The vacuum created by Japan's problems increased American influence dramatically even though the U.S. Treasury was unable to participate directly in the Thai rescue program of July 1997 and did not offer Korea bilateral financial assistance until Korea edged toward default in late December. Unlike the 1995 Mexican rescue, in East Asia the United States was a reluctant superpower—though as the scope of the crisis became apparent, the United States did not hesitate to take on its role.

WILL CONGRESS FUND THE IMF?

Ironically, the major threat to America's leadership in East Asia is the U.S. Congress. The House of Representatives has refused to support the Clinton administration's request for \$18 billion of new funding for the IMF. As the United States has an 18 percent shareholding in the IMF's capital and is the only country with unilateral veto power over its decisions, the IMF will be unable to expand its capital without congressional cooperation.

Some left-wing House Democrats view the IMF as a bank rescue agency that does not help ordinary people. Some conservative Republicans believe it encourages bankers to lend to borrowers of dubious credit quality. The IMF is also a victim of "globophobia." With the Cold War over, many members of Congress believe that the United States should withdraw from its traditional international responsibilities and focus on domestic concerns. Some new Republican members of Congress reportedly do not even have passports for international travel.

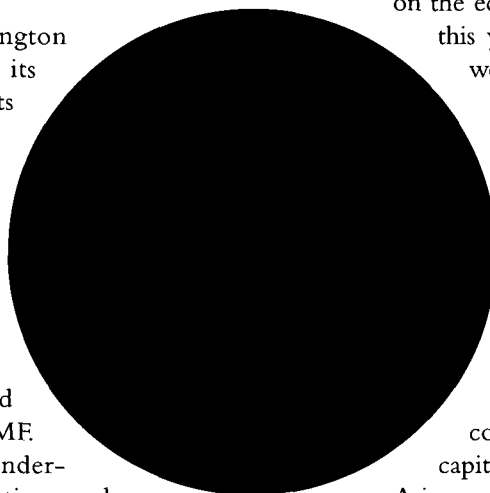
The administration still hopes that corporate lobbying will persuade Congress to support IMF funding for the same reason that it accepted GATT and NAFTA: the United States can win both economic and political advantages through international leadership. But left-wing Democrats and right-wing Republicans have joined in opposition to the IMF, suggesting that funding is still very much at risk. The booming U.S. economy has probably also eased concerns among marginal members of Congress about the impact of Asia and foreign trade on the economy. If the economy had faltered early

this year, the administration would have been well armed with arguments against opponents of IMF funding. But with the economy booming, isolationists can downplay warnings from the experts about global factors.

What remains to be seen is how other countries will respond to a U.S. failure to provide new IMF funding. Will they propose allowing the IMF to borrow? Will they propose changing member states' capital ratios so that other countries can contribute while the U.S. capital remains static? Will Japan and other

Asian countries revive the idea of regional monetary funds? None of these possibilities is by any means certain. There is a real risk that the issue of IMF funding will remain unresolved until another international financial crisis forces some action on the member states.

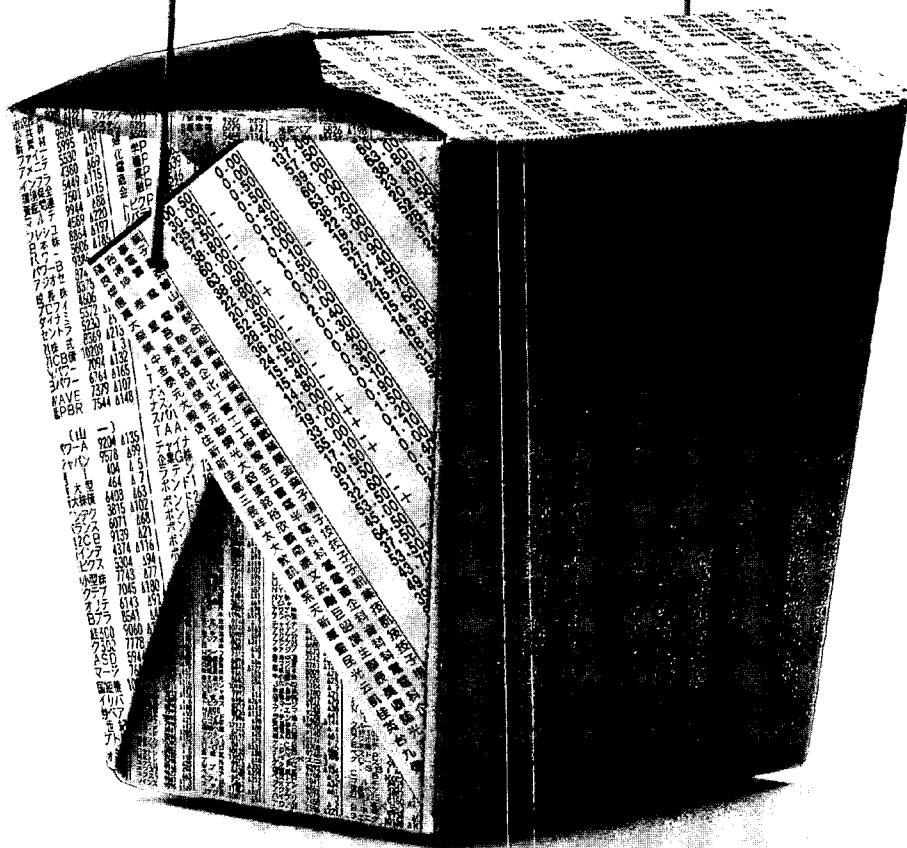
At this point only one thing is certain. The dynamism of America's economy has reenthroned the United States as the dominant player in the international financial system—while also encouraging a remarkable complacency, if not populism, in Congress about the need to develop institutions for the post-Cold War global economic order. The question now looming over both America and the world is whether Washington will be able to address the political dimensions of the globalization challenge before another great financial accident intrudes on U.S. prosperity. ■



Foreign Direct INVESTMENT

The Key to Asia's Future Economic Growth?

by Dennis J. Encarnation



THROUGHOUT 1997, East Asia's unfolding financial crises provoked scathing critiques of the role of foreign investors in the region's downward spiral. According to the critics, the same foreign investment that had helped spawn the East Asian economic miracle had come to exacerbate, if not cause, the current problems. And for many Asians, as well as for analysts elsewhere, foreign investment remains a debatable part of any proposed solution.

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GLENN PIERCE

But before rushing to judgment about foreign investors in East Asia, it is important to remember that foreign investors come in many varieties. Foreign debt must be distinguished from foreign equity. Among debt instruments, short-term borrowings must be distinguished from long-term lending. Among private lenders, commercial banks must be distinguished from nonbank creditors, including bondholders and trade financiers. And of course private lenders must be distinguished from official lenders, which can be multilateral institutions or individual foreign governments. Among the forms of foreign equity, foreign portfolio investments in local stock markets by mutual funds and other institutional investors differ from foreign direct investments (FDI), typically by multinational corporations that consciously combine equity ownership with managerial control. Even FDI must be further dissected—into new cross-border flows and local earnings reinvested in the host economy where they were generated.

Each of these forms of foreign investment has responded differently to East Asia's ever-changing opportunities and risks. Discerning these differences is critical to understanding both the likely causes of, and the potential solutions to, the region's current financial crises. Among potential solutions, foreign direct investment figures prominently. Indeed, throughout the crises, FDI has remained one of the few private sources of foreign investment for much of East Asia. And because foreign direct investment often facilitates the cross-border transfer of foreign technology as well as better access to foreign markets, a credible case can be made that it will become even more critical to East Asia's future economic growth.

FDI IN THE CRISIS ECONOMIES

The external financing of East Asia's five most afflicted economies—Indonesia, Korea, Malaysia, the Philippines, and Thailand—illustrates foreign investors' varied responses to the financial crises (see table 1). Before 1997 these five economies financed their current account deficits and increased their foreign exchange reserves principally through private commercial borrowings, largely short-term debt regularly rolled over year after year. They supplemented these borrowings with additional foreign loans from bondholders, trade creditors, and other nonbank lenders, as well as with foreign portfolio investments by mutual funds and other institutional investors interested in these "emerging markets."

During 1997 the pattern changed dramatically. As

multiple crises unfolded, foreign direct investment and nonbank credit quickly became the only remaining private sources of foreign investment in all five economies. Foreign commercial banks withdrew large sums, as did foreign portfolio investors. To finance these new foreign investment outflows as well as ongoing current account deficits, the five countries had to turn to official, especially multilateral, sources of external financing. But securing access to such funding necessitated individual negotiations with the IMF—except in the case of Malaysia, which has to date held the IMF at bay.

The Institute for International Finance predicts that this year foreign direct investment will be the sole private source of net foreign capital inflows; the *only* alternative will be funding from official sources, principally the IMF, the World Bank, and other multilateral institutions that impose major conditions on their lending. Not surprisingly, as other sources of foreign investment dry up, governments in the region have sharply escalated their competition for foreign direct investment.

COMPETITION FOR FOREIGN EXCHANGE

With increased exports critical to recovery, East Asian governments are competing fiercely for foreign direct investment in export-oriented projects.

With increased exports critical to recovery, all five governments are competing fiercely for foreign direct investment in export-oriented projects. The Institute for International Finance estimates that the five will collectively record current account surpluses during 1998, thanks both to a contraction in domestic demand and related imports and to an increase in merchandise exports, including those linked to foreign direct investment. Foreign direct investment has thus emerged as an important source of foreign exchange for crisis-afflicted economies not only on their capital account, but also on their current account (through exports).

The role of foreign direct investment varies widely across the region's economies and industries. Much of it is concentrated in manufacturing, where government competition is most intense, especially in Southeast Asia. There, Indonesia, Malaysia, and Thailand have become destinations for foreign direct investment and are likely to remain so, as reinvested earnings grow along with economic recovery. Korea has long sought to limit foreign direct investment in manufacturing through elaborate capital controls. Although Korea has begun to dismantle those controls, the economic impact of Korea's liberalization remains in doubt given the uneven experiences of prospective foreign investors there.

In financial services, Korea has much in common with Indonesia, Malaysia, the Philippines, and Thailand.

In all five, foreign direct investment in banking and other financial services has long been severely restricted by capital controls that largely relegated foreign investors to niche markets. But these controls have probably limited cross-border transfers of foreign technology. In manufacturing, Korea and other countries have long preferred to unbundle technology from foreign direct investment whenever possible through licensing agreements. But in financial services, technology licensing tends to be much less common, making foreign direct investment more critical to the cross-border transfer of financial processes and products, as well as managerial skills, from more advanced markets. Foreign direct investment may thus be crucial to the long-term restructuring of financial services in afflicted East Asian economies.

INTRA-ASIAN FOREIGN DIRECT INVESTMENT

While the troubled economies of East Asia seek foreign direct investment from abroad, most of it comes from elsewhere in the region. Japan has long been Asia's largest source of foreign direct investment. And Asia has for years been second only to the United States as a destination for Japanese foreign direct investment. But during the 1990s fresh outflows of Japanese foreign direct investment began to slow. At home the popping of Japan's bubble economy early in the decade combined with subsequent recessions to limit the value of fresh outflows; while financial crises in Indonesia, Malaysia, and Thailand—all host to sizable shares of Japanese foreign direct investment—limited the value of reinvested earnings. These problems at home and abroad are likely to diminish Japan's relative importance as a source of foreign direct investment flows to other Asian economies, especially those in financial crisis.

Meanwhile, other Asian economies have become more important sources of intra-regional foreign direct investment. Indeed, the intra-regional bias of foreign direct investment from these other Asian investors has become more pronounced. According to a recent study by the Japan External Trade Organization, by 1996 Hong Kong had become East Asia's chief source of annual foreign direct investment inflows. Estimates of Hong Kong's FDI outflows are no doubt boosted by its intermediation of capital flows originating elsewhere (typically Taiwan and mainland China). But Hong Kong is likely to maintain its status as a major foreign investor in its own right, as well as a key center for capital intermediation in Asia,

as long as it can continue to weather Asia's financial crises. Should these crises spread, Hong Kong's status as a principal source of foreign direct investment and other capital outflows to the rest of Asia increases the risk that it will suffer from this contagion.

According to official statistics, the region's other newly industrialized economies—Korea, Singapore, and Taiwan—are the next largest sources of foreign direct investment. The official statistics underestimate the relative value of their FDI, especially that of Korea and Taiwan, where home-government policies have often conflicted with corporate strategies. At any rate, Korea's relative importance as a regional source of foreign direct investment is likely to decline as it adjusts to its own financial crisis and to related crises in other Asian economies, such as Indonesia, that host sizable shares of Korean FDI. By comparison, Singapore and Taiwan, having been largely spared the current crises, may see their relative importance as Asian sources of intra-regional foreign direct investment grow. Dampening this prospect, however, is the heavy concentration of their FDI in Indonesia, Malaysia, the Philippines, and Thailand. Regardless, the newfound status of Singapore and especially Taiwan has already begun to produce subtle but important changes in the political economy of East Asia, as evidenced recently by Taiwan's diplomatic forays across the region.

Asia's financial crises have brought the United States back into East Asia as a renewed economic and political actor—with broad security implications.

CHINA AND BEYOND

Much of this intra-Asian foreign direct investment, especially that from Hong Kong and Taiwan, is concentrated in mainland China. According to World Bank estimates, last year China attracted more than half of the projected \$70 billion in foreign direct investment flowing into Asia. This status is quite new: as recently as 1990, China was second to Singapore as a recipient of new FDI inflows. Any estimates of China's FDI inflows must be corrected for the circular flow ("roundtripping") of foreign direct investment from, and then back to, China—nearly all via Hong Kong. But after correcting for roundtripping that may make up as much as a quarter of all FDI officially recorded in China, China still accounts for well over two-fifths of FDI flows into Asia.

The roundtripping of Chinese investors is one sign that government competition for FDI extends well beyond the troubled economies of Southeast Asia. China's discriminatory application of investment incentives so strongly favors Hong Kong and other foreign

Table 1. Total External Financing for Indonesia, Korea, Malaysia, the Philippines, and Thailand
(Billions of U.S. dollars)

	1996	1997	1998
Current account balance	-54.9	-26.0	17.6
External financing (net)			
Foreign direct investment	7.0	7.2	9.8
Portfolio investment	12.1	-11.6	-1.9
Commercial bank debt	55.5	-21.3	-14.1
Nonbank private creditors	18.4	13.7	-3.2
Multilateral financial institutions	-1.0	23.0	18.5
Bilateral creditors	0.7	4.3	6.1
All other (net, including errors and omissions)	-19.6	-11.9	-5.7
Reserves (excluding gold)			
(- = increase; + = decrease)	-18.3	22.7	-27.1

Source: Institute for International Finance, "Capital Flows in Emerging Market Economies," January 29, 1998. Figures for 1997 are projections; figures for 1998 are estimates.

investors that domestic Chinese investors feel compelled to roundtrip through Hong Kong to qualify for Chinese government concessions when they return to China. But intra-regional, inter-governmental competition does not end here. China and other Asian governments, for example, may also compete in devaluing their currencies to boost exports from existing (foreign and domestic) producers, as well as to attract new investments from prospective (again, foreign and domestic) producers. By this logic, currency devaluations outside of China, across much of the rest of East Asia, have intensified pressure on Chinese policymakers to respond by devaluing their own fixed-rate currency, thus raising the specter of a downward spiral of exchange rates across the region, as governments and speculators alike respond to competitive pressures.

Because China and other East Asian economies are increasingly integrated, not so much through trade but through foreign direct investment and other capital flows, government policies and corporate strategies in one economy inevitably shape policies and strategies elsewhere in the region. Thus, the financial crises afflicting Indonesia, Korea, Malaysia, the Philippines, and Thailand quickly can spill beyond their national borders, as the case of Charoen Pokphand (CP) shows. A Sino-Thai conglomerate with FDI spread across the afflicted economies of Southeast Asia, CP is also one of the oldest and largest foreign investors in China. But according to recent press reports, CP's regional investments in China and elsewhere are now threatened by its difficulties in rescheduling its mounting debt both at home and

abroad. CP's case, hardly unique, illustrates how intra-Asian FDI contributes to a larger contagion effect threatening to spread financial crises across the region, back and forth between Asia's home and host economies.

IMPLICATIONS FOR THE UNITED STATES

The United States runs a much smaller risk of importing Asia's financial contagion through foreign direct investment. Outside of Japan, Asia has typically accounted for only about 10 percent both of the cumulative stocks of U.S. foreign direct investment abroad and of annual U.S. FDI outflows—only slightly more than U.S. FDI in South America. And more than three-fifths of the cumulative stock of U.S. foreign direct investment in East Asia is in Singapore and Hong Kong, both largely unaffected to date by the region's financial crises. According to the JETRO study cited above, during 1996 both Japan and Hong Kong had FDI

inflows into East Asia with a dollar value double that of inflows from the United States. U.S. inflows even lagged those of the 12-member European Union.

But the East Asian financial crises are likely to increase both the importance of East Asia to American multinationals and the relative importance of U.S. foreign direct investment to that region's economies. Helping to fund this expansion is the robust profitability recorded by American multinationals at home. Indeed the U.S. press is replete with news of American multinationals seeking to exploit new opportunities in East Asia resulting from sharp declines in local share prices and a sharp rise in the relative value of the U.S. dollar. Exploiting these new Asian opportunities are a "Who's Who" of American multinationals—General Motors in Korea and China, Ford in the Philippines, Citibank and GE Capital in Japan, to name but a few. Such U.S. foreign direct investment is likely to figure prominently in the future growth and structural adjustment of a growing number of East Asian economies.

Viewed more broadly, the anticipated increase in U.S. foreign direct investment across East Asia heralds a much larger set of important changes in that region's political economy. Asia's financial crises have brought the United States back into the region as a renewed economic and political actor—with broad security implications. Not that long ago, America's withdrawal from Asia was a hot topic widely debated on both sides of the Pacific. The response of the U.S. government and American multinationals to Asia's financial crises has largely ended that debate. ■

IMPLICAT

BY MIKE M. MOCHIZUKI

In the first place, the economic woes besetting Asia's developing countries may provoke internal political and social instability that could spill over into the international arena. Most worrisome is Indonesia. Even before the economic crisis, Indonesian politics was entering a delicate transition phase. Questions about President Suharto's health had spurred popular discontent over authoritarian rule and, with it, speculation about democratization in a post-Suharto era. But before an orderly succession could be mapped out, the economic crisis toppled the main pillar of Suharto's political legitimacy: successful economic development. Austerity measures imposed by the IMF as the condition for Indonesia's financial bailout added to the explosive mix. After social unrest escalated into violent rioting in Jakarta in May, Suharto reluctantly stepped down and transferred the reins of government to B. J. Habibie, his chosen successor.

Indonesia's geopolitical importance cannot be overemphasized. It is the world's fourth most populous country. It has been a moderate force in the Islamic world. It has served as a valuable counterweight to China, especially in territorial disputes in the South China Sea. About 40 percent of the world's commercial shipping goes through one of the four key straits in the Indonesian archipelago, as does the bulk of the oil that Japan and South Korea import.

President Habibie must now walk the tightrope between restoring social order and pursuing economic and political reform. Lacking a firm political base of his own, he will have to rely on the military to wield power. Although hardly anyone expects Indonesia to go the way of Yugoslavia, with state collapse and civil war, few anticipate a smooth transition to democracy. Economic stabilization may be the prerequisite for free and fair elections, but stabilization will be impossible unless the new government gains popular legitimacy by offering the hope of a more open political system. The very process of political liberalization, however, might unleash ethnic conflicts and separatist movements that will challenge Indonesia's ability to preserve national cohesion.

Other states in the region are doing better at weathering the crisis politically. Last fall Thailand avoided a military coup and put in place a new government committed to implementing financial reforms to get its economy back on track. Upon his election as president of South Korea,

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Kim Dae Jung convinced his fellow citizens of the need to endure the immediate pain of austerity to lay the basis for a brighter future. The Malaysian government has so far succeeded in lowering economic expectations, despite President Mahathir Mohamad's charges of international financial conspiracy against his country. And in the Philippines, popular protests against economic liberalization have not damaged democratic processes. In fact, the newly elected president, Joseph Estrada, may be able to use his brand of populism to secure popular acquiescence to economic reform.

Much depends on how soon the economic situation can be turned around. If joblessness continues to rise sharply and food shortages worsen, social unrest will severely test these still fragile political systems.

TENSION OVER MIGRANT WORKERS

The economic crisis could also cause interstate tensions to flare over the flow of migrant workers. Until recently, with growth rapid and unskilled labor in short supply, Malaysia, Singapore, and Thailand often turned a blind eye to the illegal entry of foreign labor. Of Malaysia's nearly 2.5 million foreign workers—more than 20 percent of its labor force—about 800,000 are believed to be illegal immigrants from Indonesia. And some 1 million unauthorized foreign workers, the great majority coming from Myanmar, labor in Thailand.

The regional economic woes have simultaneously lowered the tolerance of the more developed countries for illegal foreign workers and forced the downtrodden in the less developed countries to seek jobs and economic relief in neighboring countries. For Indonesians, the sharp drop of their currency relative to those of Malaysia and Singapore makes the prospect of working abroad even more attractive.

Singapore has cracked down harshly on illegal immigrants, and both Thailand and Malaysia are repatriating foreign labor. Thailand has already sent more than 100,000 workers back to Myanmar with many more to follow. This spring Malaysia deported boatloads of Indonesians to deter the influx of illegal workers. Indonesian authorities eager to preserve legal job opportunities for their citizens in Malaysia have so far refrained from openly protesting.

But in this tense socioeconomic climate, regional amity may not survive. The orderly repatriation process could yield to violence and widespread human rights abuses. Ethnic

conflicts and links to organized crime may also complicate the handling of migrant workers.

THE KOREAN CONFLICT

Another worrisome security implication of the East Asian economic crisis involves the Korean conflict. In fall 1994, the United States and North Korea averted a military confrontation over North Korea's nuclear weapons program by signing the so-called Agreed Framework. North Korea agreed to freeze its nuclear facilities and eventually to submit to thorough international inspections to determine whether it has abided by its commitments under the Nuclear Non-Proliferation Treaty. In return, the United States offered, in cooperation with South Korea and other countries, to build two new light-water nuclear reactors and to provide heavy petroleum in the interim. Seoul was to provide the bulk of the funds for building the reactors.

Although President Kim Dae Jung has vowed to honor South Korea's commitments under the nuclear accord, domestic politics may complicate matters. Burdened by IMF-imposed austerity measures, South Koreans may be reluctant to allocate the billions of dollars to build the reactors. Any sign that South Korea or the United States is reneging on its side of the bargain, however, could provoke North Korea to renewed nuclear brinkmanship. Moreover, if political and social strife should emerge in South Korea under the strains

of austerity, North Korean leaders might be tempted to revive their sabotage and other hit-and-run tactics in a reckless effort to gain a political advantage over the South.

But the picture is not completely bleak. Since the election of Kim Dae Jung, Seoul has become more energetic about reaching out to Pyongyang to revive the North-South dialogue. The economic troubles in South Korea may also make North Korea less apprehensive about dealing directly with its southern adversary. The time may now be ripe for Seoul to present a bold initiative that offers Pyongyang a plausible way out of its disastrous economic plight. For example, in exchange for concessions on security issues—adopting confidence-building measures, participating in agreements to reduce military forces, and pulling back military assets from the demilitarized zones—North Korea could gain foreign aid and investments as well as removal of various commercial sanctions. Given South Korea's own financial difficulties, however, both Japan and the United States would have to contribute substantially to such a deal.

SLOWING PROGRESS TOWARD REGIONAL SECURITY

The economic turmoil in East Asia also threatens to halt multilateral security dialogues. In 1994, the ASEAN Regional Forum (ARF) was launched as the first government-level multilateral dialogue on security issues for the entire Asia-Pacific region. Skeptics greeted the initiative as a mere "talk shop" lacking in substance. But in just a few years, ARF has moved beyond the annual perfunctory dinner meetings of foreign ministers to convene working groups on issues such as confidence-building, preventive diplomacy, peacekeeping operations, and managing and resolving regional conflicts. Based on these intensive discussions, ARF was steadily moving toward serious official talks to codify and operationalize common security norms to enhance mutual trust.

The regional economic crisis threatens ARF's momentum. With East Asian governments devoting most of their human resources to economic issues, multilateral security dialogues now get scant attention. Some countries lack the funds to field strong delegations to ARF-related gatherings and do the spadework on behalf of this fledgling institution. The same financial shortfall may derail the so-called Track-II dialogues—those involving nongovernmental regional security experts—that have been critical in nurturing consensus on security matters in the diverse and geographically expansive Asia Pacific.

Regional leaders must recognize that the recent economic upheavals make it more imperative than ever to forge a regional security community. Ironically, with governments forced by financial crisis to rein in their military modernization programs, the timing may be just right to promote greater transparency about military policies. The opportunity should not be missed.

MAJOR POWER RELATIONS

Finally, the East Asian economic storm raises uncertainties about relations among the major powers of the region—China, Japan, Russia, and the United States. In recent months, the relationship between Japan and the United States has been strained. Many U.S. policymakers and opinion leaders blame Japan for contributing to Asia's financial mess and accuse it of not doing enough to help resolve the crisis. And without disagreeing with many of the policy prescriptions pushed by Washington, more and more Japanese are becoming resentful of heavy-handed U.S. pressure on Japan to stimulate domestic demand and deregulate its economy. As the U.S. trade deficit with Japan begins to soar again, bilateral economic issues could become politically explosive, especially if the American business cycle heads downward. Though not grave enough to imperil the U.S.-Japanese security relationship, such frictions could deplete the reservoir of goodwill between these two countries.

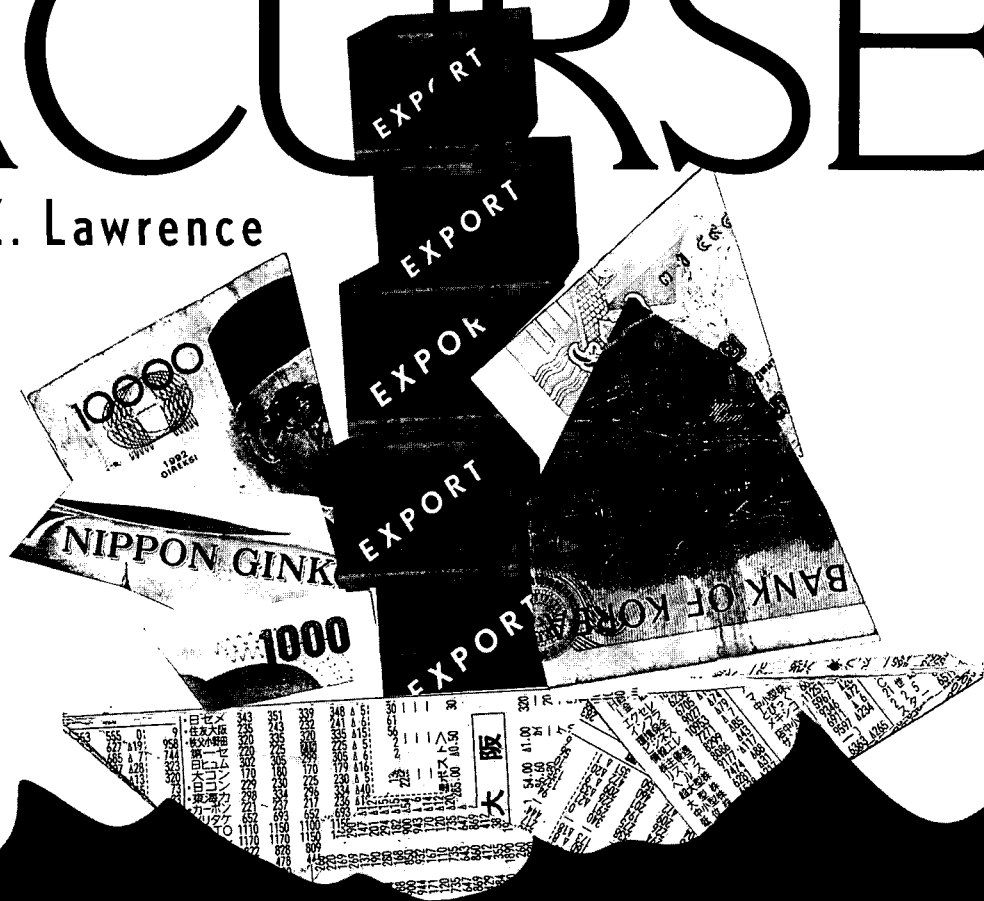
Thus far the economic crisis has not harmed U.S. relations with China and Russia. Beijing has in fact scored diplomatic points by promising not to devalue its currency, and Washington and Moscow are still working hard to maintain a cooperative relationship despite the eastward expansion of NATO. But these are not grounds for complacency. Although China may have escaped the East Asian contagion, its financial system remains shaky. Russia is still struggling to revitalize its economy, and the financial problems in East Asia may inhibit the flow of much-needed foreign capital into Russia. Given the fragility of democratic institutions in Russia and the difficult political transition still ahead for China, prolonged economic stagnation in East Asia that has an enervating effect on the world economy as a whole will make it that much harder to establish the domestic political foundations for great power cooperation.

Viewed more optimistically, the security risks from the regional economic turmoil may in fact be impelling the major powers to push ahead on improving bilateral relations. Washington and Beijing appear eager to keep their relationship on an upward track. The recent decision to resume the cross-strait dialogue between China and Taiwan will further ease U.S.-Chinese tensions. Not to be left behind diplomatically, Japan and Russia have agreed to develop jointly the disputed "northern territories" and sign a peace treaty by 2000. Japan and China have also revived their ties after a period of tension over China's nuclear tests and Japan's decision to strengthen its defense partnership with the United States. This diplomatic pattern of "concerted bilateralism" could give the region the necessary resilience to weather the East Asian economic crisis in a spirit of cooperation rather than conflict.

BLESSING OR CURSE?

by Robert Z. Lawrence

Robert Z. Lawrence holds the New Century Chair in International Trade and Economics at Brookings. He is also on the faculty of Harvard University's Kennedy School of Government. He is the author, with Gary Burtless, Robert E. Litan, and Robert J. Shapiro, of Globaphobia: Confronting Fears about Open Trade (Brookings/Progressive Policy Institute/Twentieth Century Fund, 1998).



GLENN PIERCE

The East
Asian Crisis
and
America's
Trade
Deficit

Table 1. U.S. NET NATIONAL SAVING AND INVESTMENT
(As a percent of net national product)

	Net National Saving		Net National Investment		Employment (millions)
	Private	Government	Domestic investment	Net foreign investment, or current account	
1981	9.7	-0.1	9.9	0.3	100.4
1987	6.7	-1.1	9.0	-3.8	112.4
1991	7.2	-2.3	4.9	0.1	117.7
1997	6.2	1.1	8.3	-2.2	129.6
Change					
1987/81	-3.0	-1.0	-0.9	-4.1	12.0
1997/91	-1.0	3.4	3.4	-2.3	11.9

Source: Economic Report of the President, tables B-32 and B-36; Survey of Current Business.

But the conviction that large trade deficits must be a problem merits a closer look. Efforts to lower the trade deficit by erecting new barriers to the U.S. market could in fact be disastrous. Both the world and the United States could be much better off if the deficit is allowed to grow.

The key is understanding the central role of the U.S. trade deficit in stabilizing the world economy. Today, a big challenge for the countries of East Asia is restoring international creditworthiness. Whatever the reasons for their problems, the questions raised about all their financial systems will make it harder for them to borrow in the immediate future. One result of the crisis has been to shift trade balances in these countries toward surplus. As their currencies have plunged, and their growth rates fallen, imports have plummeted. Over time, the depressed real exchange rates will also stimulate their exports. The OECD expects the current account of the affected countries to increase \$70 billion by 1999.

The counterpart to the Asian surplus must be larger current account deficits (or smaller surpluses) elsewhere. If the Asians draw less on the global pool of savings, other countries should draw more to prevent a global downward spiral into recession. A big part of the adjustment will take place in the United States, in part because Asian currencies have all declined against the dollar and in part because U.S. growth remains robust.

Many Americans complain that the United States is being called on to do more than its fair share. Why should America be the global borrower of last resort? Americans particularly blame Japan, and to a lesser extent Europe, both of which lend more to Asia and yet are being expected to play much smaller roles in countering the East Asian shift toward surplus. The assumption behind this view, of course,

is that trade deficits are necessarily bad—and the assumption is so ingrained that we commonly describe a movement toward larger trade deficits as a “deterioration,” a movement toward surplus as an “improvement.”

Trade deficits are seen as bad for two reasons. First, they are supposed to cost jobs. In 1996, each \$1 billion value-added in U.S. manufacturing was associated with 14,000 jobs. People often extrapolate from such numbers to conclude that an additional trade deficit of \$100 billion must entail the loss of 1.4 million jobs. Second, trade deficits are supposed

to lead to greater international liabilities. It is imprudent for the United States, already the world's largest net debtor country, to borrow more because the obligations will have to be either serviced or repaid.

To see how these concerns could be wrong, it is necessary to remember that there are three equivalent definitions of the current account. The most common and obvious is that the current account is equal to the difference between exports of goods, services, and gifts *to* foreigners and imports of goods, services, and gifts *from* foreigners. If the United States has a deficit, it will be buying more from foreigners than they buy from it. But according to the second definition, the current account must also be equal to the difference between national income and spending. If the United States has a current account deficit, its national spending (on both consumption and investment) exceeds its income and it must either be borrowing from foreigners or selling off foreign assets. By the third definition, the current account equals the difference between national saving and investment. If the United States has a current account deficit, its domestic investing exceeds national saving (the sum of private saving and government saving—or deficits).

Recognizing that the current account equals the difference between income and spending is useful in thinking about the links between the current account and employment. The current account will be in deficit as long as spending exceeds income. But that deficit could occur in the face of very different spending and investment levels. Those who believe that trade deficits necessarily mean a drop in employment have in mind a current account deficit in which income (and thus employment) is falling faster than spending. But what if spending exceeds

income and yet both are *rising*? In other words, the current account deficit and employment could both be growing!

Recognizing that the current account equals the difference between national investment and saving is useful in thinking about the links between the current account deficit and international indebtedness. Is it good or bad to get into debt? It depends on what you are doing with the money. A current account will be in deficit as long as investment exceeds saving. But that deficit could be associated with very different levels of saving and investment. Those who believe that increased international indebtedness reduces future incomes have in mind a current account deficit in which domestic saving falls and the country is borrowing to consume. But what if productive domestic investment is boosted by international borrowing? In that way, a current account deficit could raise future incomes.

A TALE OF TWO CURRENT ACCOUNT DEFICITS

These observations are not simply theoretical niceties, as table 1 makes clear. The table compares two recent episodes (1981–87 and 1991–97) in which the U.S. current account moved from surplus to deficit—in both cases, to a deficit of around \$170 billion.

Strikingly, employment expanded strongly during both episodes. In both the 80s and the 90s, as the U.S. economy recovered, spending increased more rapidly than production. Basically, in both periods, the trade deficit reflected the strength of U.S. spending, rather than a fall in incomes. Americans were buying more, both from U.S. producers and from producers abroad. During the years between the two periods, by contrast, when the economy fell into recession, unemployment grew and the current account deficit shrank—implying that U.S. spending fell faster than income.

What about the rise in U.S. international indebtedness? Was the United States borrowing to offset less domestic saving or to finance more domestic investment? In this respect the deficits of the 80s and the 90s are quite different.

In the 80s, the current account deficit clearly reflected a saving bust. The familiar part of this story is the rise of the government deficit, which grew by 1 percent of NNP between 1981 and 1987. Less familiar, perhaps, but even more important quantitatively was the plunge in the private saving rate by a full 3 percentage points of NNP. There clearly was no investment boom. Net domestic investment as a percentage of NNP fell by 0.9 percentage point. Thus the foreign borrowing appears not to have been devoted to income-raising investments.

In the 90s, the spending patterns driving the deficit have shown noticeable differences. Most striking are the dramatic increases in net national saving (because of the declining federal government deficit) and in net domestic investment.

This trade deficit looks more like an investment boom than a saving bust, which may help explain why it has not given rise to as much concern.

Enthusiasm for the performance in the 90s should be tempered by awareness that—perhaps in response to the dramatic rise in national wealth due to the booming stock market—personal saving has continued to fall (from 5 percent to 3.1 percent of NNP). And both net national saving and net national investment remain much lower shares of NNP than they averaged in the 1960s and 1970s. Nonetheless, these data underscore the central point that current account deficits are not always reasons for concern. First, as long as income (and thus production) is growing strongly there need be no rise in overall unemployment even if spending is growing faster than income. And, second, as long as spending falls heavily on productive investment there need be no concern over the rise in international indebtedness.

The key to ensuring that the current account deficit that is emerging in response to the Asian crisis is benign, therefore, is generating strong investment growth in the United States. The lower long-term interest rates and strong stock market in early 1998 should help. As long as the economy can absorb additional resources without inflation through the current account, the Federal Reserve can avoid raising interest rates.

This does not mean that no Americans will lose jobs to Asian competition. While growth in U.S. spending will spur demand for workers both at home and abroad, some expenditure-switching will mean that foreign goods are bought and domestic goods are not. In particular, manufacturing could see some painful adjustments. The best chance for these workers is finding work in other parts of an economy in which growth is robust. As Robert Litan, Gary Burtless, Robert Shapiro, and I have described in our book *Globaphobia: Confronting Fears about Open Trade*, training and adjustment assistance could also be improved.

But the bottom line is this: if domestic saving is too low to fund profitable investment opportunities in the United States, we are better off borrowing from abroad and running a deficit than avoiding the deficit and losing the opportunity to improve our well-being. If the prospects for investment in the United States are (temporarily) better than those in Asia, a larger U.S. current account deficit may be necessary to maintain not only global incomes but also a desirable allocation of global resources.

Over the long run, of course, U.S. incomes would be even higher if we save the money ourselves, rather than borrowing it from foreigners. The best way to reduce our current account is not to cut down on investment but to raise national saving. Given how hard it has been to design effective policies to stimulate private saving, it might be desirable for the federal government to run budget surpluses in the years to come. ■



V I E W P O I N T S

Robert D. Hormats

THE IMF NOT PERFECT, BUT ESSENTIAL

Robert D. Hormats, of Goldman, Sachs, and Co., Lawrence B. Lindsey, of the American Enterprise Institute, and Barry Bosworth, of Brookings, discussed the role of the IMF in the Asian financial crisis at a National Issues Forum at Brookings on February 17.

The International Monetary Fund has three important roles in international financial crises. The first is to help countries to fashion programs to restore currency and market stability. The second, under certain circumstances at least, is as a lender of last resort. The third is as a rallier of others in support of actions necessary to end the crisis. The IMF is far from perfect in determining the conditions required for countries to get out of difficulties. But it is far better at doing so than any single government—and even if it weren't, no single government would want that job, for very good political reasons.

To those who want the IMF to stay out of the business of managing international financial crises and “let the market do it,” my response is “Yes, the market *can* do it—but at what pain, what social discontent and political instability, and what contagion worldwide?” It simply is not worth the high cost and high global, systemic risk.

Having said that I think the IMF does have a role, let me add that I also think that it can surely improve its performance in that role.

DOES THE INTERNATIONAL MONETARY FUND HAVE A ROLE IN ASIA?



Changes in the international environment have made it much harder for the IMF to perform its traditional role. The inflow of capital into individual countries has soared. The ratio of private capital to the resources that the IMF has at hand is now enormous.

Up against the huge short-term money flows and the potential they carry of exodus, the IMF's ability to supply capital has diminished considerably.

There are three reasons for the market greater flows. One is technology, the ability to move large amounts of money across borders very quickly. A second is demography. Baby boomers are saving vast amounts of money for retirement, and their pension saving has led to a greater institutionalization of funds. And the third reason for the increased capital flows is the growth of hedge funds. When these funds see problems, they exit quickly, greatly increasing the volatility of capital. Naturally, all these developments necessarily herald change in the IMF's role.

Whatever one thinks about the origin of the Asian financial crisis, two important aspects of the crisis were the mispricing of risk—the excessive optimism behind all that money going into Asia—and the excessive confidence that the exchange rates were stable or guaranteed to a degree by governments. That myth, of course, was punctured by the collapse of the Thai baht.

Another important aspect of the crisis was that the increase in flows into the banking systems in Asia was not accompanied by an increase in the ability to judge credit risk—to judge where the money ought to go. The lack of expertise in judging credit risk led to large structural imbalances in commercial real estate and in certain cases in industry.

Now, what do all these developments suggest with regard to changes in the role of the IMF? I would point out three ways. First, the IMF should be insisting on improved disclosure—not just government accounting, but disclosure of private-sector borrowing, especially private overseas borrowing—corporate and private banking combined. The goal should be to encourage countries to move from what I call “insider capitalism” to “accountability capitalism.” Markets are going to insist on greater accountability. If they don't get it, they're going to misprice risk, either on the upside or the downside. Much progress has been made since the 1995 Mexican crisis, but more is required.

Second, the IMF should insist on a more active dialogue with the broad private sector—banks, mutual funds, all the people who are moving money around. Such a dialogue would help to identify risk and to share perceptions about the market.

And third, the IMF should increase its general supervisory role. It should insist that individual countries improve supervision and regulation of their own domestic banking systems.

Domestic banking deficiencies caused many of the problems in Asia and exacerbated others. The improvement in banking guidelines should be undertaken through the Bank for International Settlement. The BIS has already come up with capital adequacy requirements

for banks of the industrialized G-10 countries. It should also subject emerging countries to guidelines that apply to bank overseas exposure, particularly short-term exposure relative to long-term exposure.

Several points in closing. The structural issues that the IMF and the BIS ought to deal with are not the traditional IMF macroeconomic issues, but rather changes in corporate governance, investment regimes, and trade and banking regimes. But is it appropriate for the IMF to be involved in such domestic issues? Certainly the IMF should make clear why it is urging changes in these areas to avoid appearing arbitrary. It should also demonstrate why such changes are necessary to promote financial and currency stability. Without strong domestic support, any reforms engineered by the IMF will not last. There is a great potential for backlash, for countries backing away from reforms.

Finally, there is a need for democratic accountability. It is extremely important now for the industrialized countries to conduct a much more open dialogue about the role of the IMF and why it is important. Not long ago it was not difficult for a U.S. presidential administration to get Congress to approve spending for the IMF. It was a matter of sending the experts to testify before a few committees to explain why the IMF was needed. Most members of Congress would just go along with the administration. It wasn't a visceral issue then. Now it is—because the IMF raises questions about globalization, about why we should be helping countries that do not make the domestic changes we want or enact the policies that we prefer.

We need an active dialogue in our own country about why it's in our own interest to provide support for the IMF, the World Bank, and other such institutions. We also need to conduct the same dialogue in emerging countries. It's extremely important to gather substantial public support for programs the IMF is insisting that other countries undertake, particularly in democratic countries.

In short, the IMF can play, has played, and is playing an important world financial role. Certainly, in the current financial environment, changes are needed. The role of the IMF is already being evaluated, as it should be—in Congress, in the administration, and in the IMF itself. If the IMF is going to do the job it's supposed to do in this dramatically changed international financial environment, improvements are essential. But the centrality of the IMF's mission and the vital role it plays in the international monetary system argue for strong U.S. support.

DOES THE INTERNATIONAL MONETARY FUND HAVE A ROLE IN ASIA?

Lawrence B. Lindsey

THE IMF NO ROOM FOR AN INTERNATIONAL AGENCY IN A GLOBAL ECONOMY



The international system set up after World War II was appropriate for that era. But now it is time to move from an international (“between nations”) world to a global one. The problem today is that we have an economic system where conflict between creditor A and debtor B immediately becomes an international conflict. It shouldn’t.

Bob Hormats and I agree that the Asian crisis is largely a banking crisis. But unlike Bob, I don’t think this is anything new. It’s the way systems work. Banking crises and economic cycles are driven by fear and greed. Someone discovers Bangkok is a great place to open a factory. Labor there is cheap. So people start opening factories there. More people come in. Then we discover that real estate prices are rising because everyone’s opening factories. Soon we discover we need office buildings there—for all the lawyers. So commercial real estate prices rise. Then money moves in because commercial real estate prices are rising. Hey! Not only is Bangkok a good place to build a factory, it’s a good place to invest in commercial real estate. This is not a story that should be unfamiliar to any American, particularly any American bank regulator. Whether it’s Texas in 1986 or New England in 1989, the story is the same.

If the Asian crisis is a banking crisis, what sets it apart from earlier banking crises is that we did not have in place the institutions necessary to handle the downturn cycle of a banking crisis. There was no way to deal with debt that went into default. Until this past January, it was illegal for foreigners to have a major equity stake in a Korean business. Nor was there a real bankruptcy statute in any of these countries. But even if there had been, one of the key elements of bankruptcy is that the lender takes equity possession of the property once the

borrower can no longer pay. Well, if you can’t own the property, you can’t have a bankruptcy. So one of the important differences between this banking crisis and earlier ones is that the fundamental institutions of capitalism that move the real assets—commercial real estate, factories, whatever—from bankrupt hands to strong financial hands that can run them were simply not in place.

I don’t mean to say that the two are quite comparable, but I would urge you to remember Texas in 1986. Virtually all the major banks in the state went bust. Eight are now owned by foreigners, or what Texans would consider foreigners—North Carolinians and New Yorkers. The bankruptcy process was devastating. Thousands of very wealthy Texans went bankrupt. But the bankruptcies are part of the process, a way to keep productive assets in operation, to move them from weak to strong financial hands.

Now to return to internationalism vs. globalism. The world I want to see in the 21st century is one where a citizen of any country can take an equity stake in an investment in any other country, *any* other country, it doesn’t matter which. Similarly, I believe in a world where any citizen in any country can lend money to a company in any other country, and if the borrower can’t pay it back, there exists some arrangement by which it can be worked out without becoming an international crisis. That’s the 21st century we should all be working for.

The IMF is not designed for that kind of world. My world is a world of small crises, individual bankruptcies, individual purchases of one company by another, changing hands of small assets, not national crises. The IMF is structured and will always be structured as an international, not a global, institution. It is composed of member states. Member states are shareholders. Member states nominate the board of directors. And member states will act like member states always do. They will act on an international—between national governments—basis and not a global basis. Is the IMF bad? No. Some of my best friends work at the IMF. They are talented, competent people. But the world we need for the 21st century is a global, not an international, economy. ■

DOES THE INTERNATIONAL MONETARY FUND HAVE A ROLE IN ASIA?

Barry Bosworth

WHEN THE IMF CAN'T & THE MARKET WON'T SOME PRACTICAL STEPS FOR DEVELOPING COUNTRIES TO HELP THEMSELVES

In a world of mobile financial capital, the threat of financial crises will always be with us. As international investors diversify their wealth across national boundaries, the distinction between domestic and foreign investors will become meaningless. The investors, though, will use diversification and indexed funds rather than going to the trouble of learning about the countries in which they invest. They will also react strongly to news. They will "take their money and run"—from one country to another. As a result, the threat of a run against a country's currency will remain substantial.

Domestically, most countries try to control the risks of bank runs through a system in which the central bank operates as a lender of last resort, in combination with a system of prudential supervision and regulation. The IMF cannot be placed in the position of providing unprecedented resources to countries threatened by a run on their currency when it has no way of overseeing their financial institutions and ensuring that their banks have prudent policies for managing risks. Such open-ended commitments are neither credible nor desirable.

But leaving things to the market seems equally untenable. It is reasonable to stand aside from a market crisis when the only parties at risk are willing participants, but that is true neither of bank runs nor of currency crises, whose costs are large both for others within the affected country and for trading partners. We can't just say, "We won't do it." The international community has to address the problem, no matter how difficult it may be.

But the developing countries should not wait for the solu-



tion to come from the IMF. They should also reassess their own policy options. They have been urged by the international community to open their financial markets as a means of making great efficiency gains. But the international community has shown insufficient concern for the need for developing countries to create strong domestic financial systems before moving to full capital mobility. The highly touted efficiency gains made in Asia in past years, after all, have been virtually wiped out by the current crisis.

In part, financial openness in developing countries may require a greater emphasis on markets as opposed to banks. Though banks are often regarded as being better at providing financial intermediation services in the initial stages of a country's development, well-functioning markets provide a more effective risk-sharing mechanism. The existence of markets also means that a bank run will not immediately translate into a currency crisis simply because there are so few domestic options. A strong financial system, however, cannot be built overnight.

As an interim policy, developing countries could hold larger reserves to protect themselves against a currency run, though large reserve holdings eliminate much of the advantage of capital flows to recipient countries. Developing countries could also control some of the risks of a currency crisis by following the lead of Chile in monitoring and regulating the net currency exposure of its financial institutions and with measures that discourage short-term borrowing from abroad. While it has no significant restrictions on capital outflows, Chile is careful to limit the composition of the inflows. It has enforced a one-year holding period on foreign portfolio capital and direct investment and a 30 percent reserve requirement against short-term bank liabilities to foreigners. These controls have effectively limited Chile's foreign exposure without discouraging longer-term capital inflows. Chile has also used a tight fiscal policy to reconcile its need for restraint on domestic demand with a desire to avoid the high interest rates that would attract foreign capital. ■

THE FLAT

Simple, Efficient, Fair. Or Is It?

by William G. Gale

The U.S. tax system remains continually, and deservedly, under attack. Many people find taxes too complex. Analysts blame the tax system for depressing saving, entrepreneurship, and economic growth. Few people believe it to be entirely fair or transparent.

Members of both political parties have put forth plans to overhaul the current tax system. The best known is the “flat tax.” Conceived by Stanford economist Robert Hall and political scientist Alvin Rabushka in the early 1980s, the flat tax has been given legislative form in the past few years by Rep. Richard Armey (R-TX) and Sen. Richard Shelby (R-AL).

The flat tax would replace taxes on personal and corporate income and estates. Households would pay taxes on wages and pension income in excess of substantial personal and child allowances. Businesses would pay taxes on their sales less their wage and pension payments, input costs, and capital purchases. No other income would be taxed, no other deductions allowed. Businesses and individuals would face the same flat tax rate.

Proponents have made strong claims for the flat tax: it would be so simple that the tax form could fit on a postcard; it would take tax considerations out of people’s economic decisionmaking, thereby increasing efficiency and revitalizing the economy; it is a fair and airtight system.

In theory, the flat tax is, indeed, a clever, principled approach to changing the nature of federal taxation. Whether it could satisfactorily meet the competing demands placed on the tax system—fairness, simplicity, growth—and the transition to the real world is an open question.

William G. Gale is a senior fellow in the Brookings Economic Studies program. He is the author, with Henry J. Aaron, of a forthcoming Brookings book on tax policy.

FLAT TAX

IN THEORY AND PRACTICE

Just What Is the Flat Tax?

The flat tax is not an income tax, but a consumption tax. The simplest form of consumption tax is a tax on retail sales. If we switch to a consumption tax, why not just adopt the simplest?

Implementing a national retail sales tax would be problematic for several reasons. First, it would be regressive. Poor households consume a much greater share of their income than do other households. Taxing their total consumption would be a large burden, especially compared with the current income tax system, which channels money to many poor working households via the earned income tax credit. In addition, as the sales taxes that now exist in 45 states have shown, it is often hard to distinguish business-to-business sales from business-to-household sales. But if each sale from business to business is taxed, the eventual product is taxed several times, resulting in “cascading,” a problem that encourages firms to integrate vertically and also creates capricious redistributions of tax burdens across goods and people. Most important, though, a retail sales tax with a rate high enough—well over 30 percent—to replace existing federal taxes would be very hard to enforce. European countries that have tried to raise significant revenue by retail sales taxes have found that they become unadministrable at rates as low as 10–12 percent. They have therefore shifted to a different form of consumption tax, a value-added tax (VAT).

A sales tax and a VAT differ in the point at which they are exacted: a sales tax, on the final sale price; a VAT, at each stage of production. Under a VAT, each business pays a tax on the difference between gross revenues from all sales (including business-to-business sales) and the cost of materials, including capital goods. Thus it pays taxes on wages, interest, and profits, the sum of which represents the value added by the firm in providing goods and services.

The VAT avoids cascading because sales between businesses wash out. The baker who sells bread to the grocer pays VAT on the sale, but the grocer deducts the purchase in calculating his VAT. The VAT is also easier to enforce. One reason is that the seller, in trying to decide whether to report a transaction to the tax authorities, knows that the buyer will file the transaction with the tax authorities to claim the deduction for funds spent.

Like the sales tax, however, the VAT is regressive. Governments can address that problem by exempting from taxation, say, the first \$20,000 of consumption by sending each family a check for \$5,000 (assuming a 25 percent tax rate). But financing such transfers requires higher tax rates. Targeting the transfers to the poor would mean that rates would not have to be raised as much, but it would require all households to file information on income, thus sacrificing some of the simplicity gain.

The flat tax is a VAT, with two adjustments that help address the regressivity problem. First, businesses deduct wages and pensions, along with materials costs and capital investments. Second, the wages and pensions that businesses deduct are taxed at the individual (or household) level above a specified exemption. Dividing the VAT into two parts, one for businesses and one for households, makes possible the family exemptions that can ease the burden of the consumption tax for lower-income households.

How Does the Flat Tax Differ from the Current System?

Today's federal "income" tax is actually a hybrid between an income and a consumption tax. A pure income tax would tax all labor earnings and capital income, whether realized in cash, in kind, or accrued. But the current system does not tax certain forms of income, such as employer-provided health insurance or accrued gains on unsold assets. And it taxes some income more than once: in the case of corporate earnings, once at the corporate level and again at the individual level when distributed as dividends. It also taxes some items not properly considered income, such as the inflationary components of interest payments and realized capital gains. The flat tax would not tax capital income—such as interest, dividends, and capital gains—at the household level, or financial flows at any level. On the other hand, most saving—in pensions, IRAs, and so forth—is already taxed as it would be under a consumption tax.

Unlike the flat tax, the current income tax also permits dozens of allowances, credits, exclusions, and deductions. Taken together these "loopholes" reduced personal tax collections by some \$1.3 trillion in 1993, about 50 percent of the actual tax base. Eliminating them all would make it possible to reduce tax rates across the board, or set rates as low as 13.5 percent.

The income tax is graduated: its six rates—0, 15, 28, 31, 36, and 39.6 percent—rise with taxable income. Multiple tax rates increase progressivity, but raise compliance and administrative costs and the importance of the deductions. A deduction that matters little when the tax rate is 10 percent is of much more consequence when the rate is 40 percent.

But the biggest differences between the existing system and the flat tax arise not because of large inherent differences in the underlying tax base. In fact, if the flat tax allowed firms to deduct investment expenditures over time, in accordance with the economic depreciation of their assets, instead of allowing them to deduct all investment expenses the year they are made, the flat tax would then be a flat income tax.

Rather, the key point is that the differences arise because, in response to a variety of political pressures, the existing tax system has strayed from a pure income tax structure. Indeed, perhaps the crucial question about the flat tax is how it would respond to those same pressures if it were to move from idea to reality.

The Arme-y-Shelby flat tax proposal features a \$31,400 exemption for a family of four and a 20 percent tax rate. After two years the exemption would rise to \$33,300 and the rate would fall to 17 percent. (The low tax rate is possible because the proposal is not "revenue neutral"; that is, it combines tax reform with a tax cut.)

But in recent years, different variants of the flat tax have begun to take on some features of today's income tax. Sen. Arlen Specter's (R-PA) proposal would reinstate the mortgage and charity deductions. So would Pat Buchanan's, which would also tax at least some capital income at the household level. The Kemp Commission favored deductions for payroll taxes and for mortgage interest and charity. Robert Dole voiced a wish to protect deductions for mortgages, charity, and state and local taxes.

These cracks in the flat tax armor, appearing long before serious legislative action takes place, suggest that the pressures that led to an impure income tax are likely to affect the flat tax as well.

Political and Economic Dilemmas in Tax Reform

Richard Arme-y, like some other advocates of the flat tax, candidly links his proposal to big tax cuts (although he does not specify how he would cut government spending to make up for the lost revenue). Because it is misleading to compare a plan that simultaneously reforms the tax structure and cuts taxes with the existing system, I will lay out the issues raised by the flat tax without the confounding effects of tax reduction.

Tax reform that collects the same amount of revenue in a new way will necessarily redistribute tax burdens among taxpayers. Those who stand to lose often try to prevent a reform or to secure "transition relief" to avoid or delay the full impact of the new law.

Tax reform that collects the same amount of revenue in a new way will necessarily redistribute tax burdens among taxpayers. Those who stand to lose often try to prevent reform or to secure “transition relief” to avoid or delay the full brunt of the new law. The flat tax embodies this problem in stark form, because it proposes a single rate on businesses and on household money wages above a threshold, with no deductions and no transition relief.

The biggest transition problem for the flat tax involves business. Under the current system, businesses may deduct depreciation, the loss of value of capital assets over their useful lives, in computing taxable business income. Under the flat tax, businesses can deduct the full value of the asset the year it is purchased. The practical problem is what to do about assets that have not been fully depreciated when the new tax takes effect.

The pure flat tax would allow no deductions for depreciation on existing assets. But companies that lose their existing depreciation deductions will claim unfair treatment. And the stakes are high. In 1993, corporations claimed \$363 billion in depreciation deductions, unincorporated businesses about one-third that.

Similarly, under the current system many businesses have net operating losses that they can carry forward as offsets against future profits. And businesses’ interest payments are deductible because they are a cost of earning income. The flat tax would disallow both the carryforwards and the deduction for interest payments. Firms that depend on those provisions will press for transition relief under the flat tax.

Flat tax advocates have already acknowledged the need for transition relief. The Kemp Commission, for example, recommended that policymakers “take care to protect the existing savings, investment, and other assets” during a transition to a new tax system. But these political concessions carry a big price tag. Transition relief will reduce the size of the tax base and therefore require higher tax rates on the rest of the base. Policymakers will have to choose: the more transitional relief they provide, the less efficient the new tax system.

What about the Existing Deductions?

Many prominent features of the income tax have long been a part of American economic life. The original (1913) income tax allowed deductions for mortgage interest and for state and local income and property taxes. Deductions for charity and employer-financed health insurance followed by 1918.

A pure flat tax would scrap these longstanding provisions. Without question, doing so would hurt the affected sectors of the economy. That, after all, is one of the points of tax reform: using the tax code to subsidize these sectors has channeled too many of society’s resources to them. Removing the subsidy would make for a more efficient overall allocation of resources across sectors. But the affected groups are not likely to see things that way.

Under current tax law, for example, owner-occupied housing enjoys big advantages over other investments.

Homeowners may deduct mortgage interest and property taxes without being required to report the imputed rental income they receive as owners. These deductions increase demand for owner-occupied housing and boost the price of housing and land. By treating owner-occupied housing and other assets alike, the flat tax would reduce the relative price of housing. Estimates of how much range widely, but even declines as low as 5–10 percent would hurt homeowners and could affect lending institutions through increased defaults.

Confronted with these realities, is Congress likely to end the tax advantages of owner-occupied housing? Perhaps not. But retaining the mortgage interest deduction means that tax rates would have to be higher to replace revenue lost from the deduction.

The same story would unfold with each of the other long-standing deductions. Under the flat tax, health insurance would no longer be deductible by businesses and would become taxable at the flat tax rate. Jonathan Gruber and James Poterba calculate that the change would boost the price of health insurance by an average of 21 percent and reduce the number of people who are insured by between 5.5 million and 14.3 million people. Pressure to keep the deduction would be strong. But if Congress were to retain it, the flat tax base would shrink, and rates would have to rise to maintain revenues.

Likewise, terminating the charitable contributions deduction would reduce charitable giving—and at a time when cuts in government spending are being justified on the grounds that private philanthropy should pick up the slack. But retaining the deduction means a higher tax rate to maintain revenues.

Flat Tax Trade-Offs: How Much?

In short, the flat tax is unlikely to be adopted in its pure form. What are the budget implications of various policy changes to the pure flat tax structure?

By my calculations, the Arme y-Shelby plan with a 17 percent rate would have raised \$138 billion less in 1996 than the current system. Even a 20 percent rate, which Jack Kemp referred to as the maximum acceptable flat tax rate in press conferences after the Kemp Commission report was released, would result in a shortfall of \$29 billion. Allowing businesses to grandfather existing depreciation deductions—one form of transition relief—would raise the required rate to 23.1 percent. Allowing deductions for mortgage interest payments, as well as transition relief, would raise the required rate to 24.4 percent. If the deduction for employer-provided health insurance were also retained, the rate would rise to 26.5 percent. Adding in deductions for charitable contributions, individual deductions of state and local income and property tax payments, and the earned income tax credit would raise the rate to 29 percent. With all these adjustments, a tax rate of 20 percent would generate a revenue loss of well over \$200 billion. Even with a flat tax rate of 25 percent, the revenue loss would be just over \$100 billion.

Finally, retaining current payroll tax deductions for businesses would raise the required rate to 32 percent. The revenue shortfall, at a 20 percent tax rate, would be a whopping \$280 billion a year. Even at a 25 percent tax rate, the revenue shortfall would be about \$163 billion.

Politicians might find it hard to support a flat tax with these rates, since more than three-quarters of taxpayers now face a marginal tax rate of 15 percent or less, and less than 4 percent pay more than 28 percent on the margin. On the other hand, capping the rate at 20 percent or 25 percent would generate large losses in tax revenues that might also be hard to support.

One thing is clear. The flat tax is considered a simple tax with a relatively low rate in large part because it eliminates, on paper, deductions and exclusions that no Congress has dared touch.

The Flat Tax and Economic Growth

Retaining existing deductions and providing transition relief will also eat into the economic growth that flat tax advocates claim the tax will spur.

The most complete economic model that generates realistic estimates of the impact of the flat tax on growth, developed by Alan Auerbach of the University of California, Laurence Kotlikoff of Boston University, and several other economists, finds that moving from the current system to a pure, flat rate, consumption tax, with no exemptions, no deductions, and no transition relief or other adjustments, would raise output, relative to what it would have been under the income tax, by 6.9 percent after the first 2 years, 9 percent after 9 years, and almost 11 percent in the long run. These are remarkably large gains, but they vanish as the tax plan becomes more realistic.

For example, if the personal exemption is set at \$9,000, somewhat less than the \$11,000 personal exemption in the Armey-Shelby plan, and transition relief is provided for existing depreciation deductions, the economy would grow by only 0.6 percent over 2 years, 1.8 percent after 10 years, and 3.6 percent in the long run. Adding exemptions for children (which the Armey plan now provides) would drive these estimates to zero. Adding transition relief for interest deductions and retaining the earned income credit and deductions for mortgages, health insurance, taxes paid, and charity would reduce growth further. Thus, implementing realistic versions of the flat tax could even slow economic growth.

Tax Reform in the Real World

Good tax reform requires discipline. It is not hard to look at the U.S. tax code and see the need for a simpler, cleaner tax. But it is hard to look at the 1997 Taxpayer Relief Act, passed by Congress and signed by the president, and believe that the political system has the discipline to pass broad-based fundamental reform. After all, there is nothing—other than political forces and views of social equity—stopping our political leaders right now, or in any other year, from passing legislation that would broaden the tax base, close loopholes, and reduce tax rates. Those political forces and views of social equity will not vanish when the flat tax is passed. As one congressman noted, “You can’t repeal politics.”

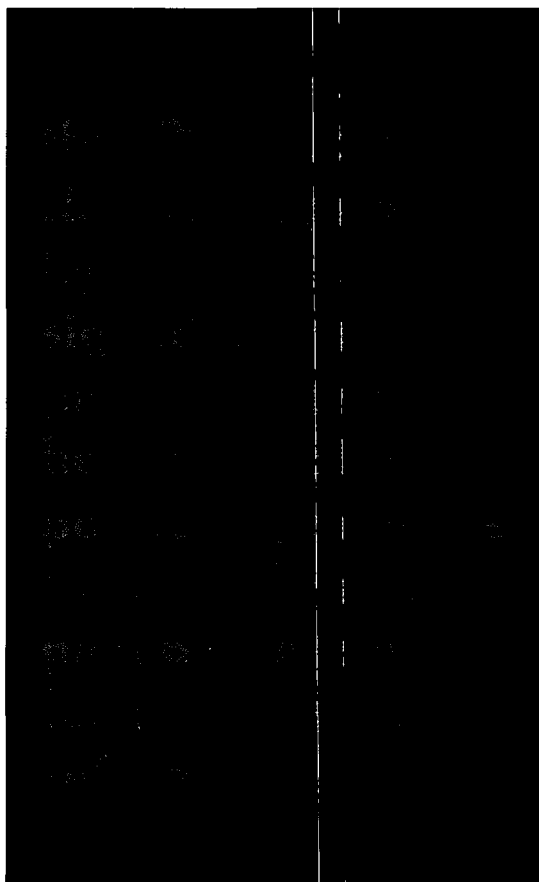
The flat tax is a simple and thoughtful response to many of the problems in today’s tax system. But tax reform is not a free lunch: we can’t get everything we might want.

There are two ways out of this quandary. One would start with the flat tax proposals and make them less pure. For example, holding personal exemptions at about their current level would generate added revenue. And coupling the lower exemption levels with a two-tier tax rate system (similar to the 15 percent and 28 percent brackets that now apply to the vast majority of taxpayers) would raise revenue, enhance progressivity, and maintain many benefits of the flat tax.

The less radical alternative would be to start with the existing income tax system and simplify,

streamlining the tax treatment of capital income, reducing the use of the tax code to run social policy, and reducing and flattening the rates. That would be an extension of the principles developed in the Tax Reform Act of 1986. Either alternative would place the resulting system somewhere between the current tax system and the flat tax on simplicity, efficiency, and equity—the three primary issues under debate.

The flat tax is an important advance in tax policy thinking and represents a thoughtful approach to several problems in the tax code and the economy. But removing the entire body of income tax law and starting over with a whole new system is a monumental task. We should approach the issue with our eyes open concerning the likely benefits, costs, and practical issues that would arise in adopting a flat tax. ■



BY ROBERT J. BLENDON, JOHN M. BENSON,
MOLLYANN BRODIE, AND FLINT WAINESS

AMERICA in Denial

The Public's View of the Future of Social Security

SOCIAL SECURITY IS ONE OF THE MOST POPULAR federal government programs. In the 1996 presidential election, voters listed Social Security and Medicare second only to the economy and jobs as the most important issue in deciding their vote.

Policy experts, national politicians, and opinion leaders have written and spoken extensively about the problems facing the Social Security trust fund and on their views of its prospects for the future. Ordinary American citizens have not been so voluble. We have been probing their views through an analysis of 11 national surveys conducted during 1997–98, including two of our own.

What we've found is a nation tied up in knots. Americans know that Social Security faces serious financial difficulties. But most also know that they are not saving—and cannot save—adequately for their own retirement. Their fears could lead to a paralysis on Social Security reform.

Robert J. Blendon, John M. Benson, and Flint Wainess, of Harvard University, and Mollyann Brodie, of the Henry J. Kaiser Family Foundation, are part of a team conducting ongoing polling on Americans' knowledge, beliefs, and attitudes about entitlements.

Americans Are Relatively Well Informed

Americans tend not to be well informed about how their government and political system operate. But when it comes to Social Security, they have a pretty fair idea of how things work. Eight in ten Americans know that Social Security is a federal, rather than state or private, program. Almost seven in ten recognize that it is a pay-as-you-go program—that is, that payroll taxes collected from workers today pay benefits for current retirees rather than going into an account to pay their own benefits when they retire.

Most also know the basics of who can receive benefits. Ninety-six percent know that workers who have paid into the program are eligible. Eighty-nine percent know that spouses of such workers are eligible. Seventy percent know that workers who have not paid into the program are not eligible.

Ninety-three percent know that people who retire on Social Security receive different monthly payments, and 79 percent know that a person can work while receiving benefits, but that there is a limit on how much he or she can earn.

Forty-nine percent of Americans know the money in the Social Security trust fund is invested in U.S. government Treasury bonds. But 21 percent think it is kept by the government as cash in the bank, 13 percent think it is invested in private company stocks, and 17 percent said they did not know. More than two-thirds know that if no action is taken, the trust fund will go bankrupt. One in four expects (incorrectly) the bankruptcy within 10 years. Nearly half realize that it is more distant. In general, the public sees the problem as one for the long-term future, not one that Congress must act on immediately because it is a crisis today.

The public has a fair sense of what is causing Social Security's financial problems. Six in ten attribute them to more people going on Social Security and to having fewer workers to pay Social Security payroll taxes. But two-thirds attribute the problems to the diversion of trust fund money to programs other than Social Security.

Table 1. AMERICANS' VIEWS ON INDIVIDUAL AND GOVERNMENT INVESTMENT OF SOCIAL SECURITY FUNDS

	Percent who favor each proposal
Individual Investment	
Let workers shift some Social Security tax payments into personal retirement accounts that they would invest on their own.	80
Let workers decide how some of their own Social Security contributions are invested.	71
Let workers have individual accounts and make their own investments with a portion of their Social Security tax payments.	64
Let workers invest a portion of their Social Security taxes in investments like the stock market, getting more money if investments do well, less if they do poorly.	60
Let people invest some of their Social Security tax payments in stock market, with benefits higher or lower than expected depending on stock market's performance.	48
Government Investment	
Invest some Social Security revenues in stock market instead of putting them all in government bonds.	50
Have government invest in private stock market a portion of Social Security reserve funds, currently invested in government bonds.	38
Keep system intact, but government invests 40 percent of Social Security revenues in stock market.	37
Invest a portion of Social Security tax funds in stock market.	36
Let government invest part of money it holds in Social Security in stock market.	29
Sources: Eight polls conducted between January 1997 and May 1998 (see box, page 48).	

Problems and Proposed Solutions

Despite knowing the financial difficulties faced by Social Security, most Americans are unwilling to raise taxes or reduce benefits. The only exception is in the case of benefits for higher-income Americans.

Only about four in ten favor increasing Social Security payroll taxes or eliminating the current Social Security payroll tax cutoff, which exempts income over \$68,400 a year. One in four

favors increasing taxes on Social Security benefits. Only one in five favors reducing benefits to retirees.

Americans generally oppose raising the Social Security retirement age even if the change is phased in over time: only one in three supports this option. Fewer than four in ten favor increasing the retirement age to 67 earlier than planned.

Support for changing Social Security cost-of-living adjustments is variable,

Table 2. GENERATIONAL DIFFERENCES ON SOCIAL SECURITY REFORM
(Percent)

Respondent's view on Social Security	Age of respondent				
	All	18-34	35-49	50-64	65+
Social Security is in crisis.	31	30	39	31	16
Social Security is not fair to people your age.	40	52	45	27	15
	All	18-34	35-54	55-64	65+
Government should completely redesign Social Security.	31	37	37	16	14
People should have individual accounts and make their own investments with a portion of their Social Security payments.	64	69	71	63	40
Government should invest in private stock market a portion of Social Security reserve funds, currently invested in government bonds.	38	50	36	32	24

Sources: *Time*, CNN, Yankelovich Partners poll of April 18, 1998, and Harvard University/Chilton poll of May 6, 1998 (see box, page 48).

depending on how the change is presented. Slightly more than half favor giving smaller yearly increases to retirees when the cost of living goes up; but only one in three favors limiting cost-of-living increases in Social Security benefits.

Many Americans are willing to consider affluence testing, but the definition of "affluence" affects the level of support. Two-thirds favor reducing benefits for upper-income people if no income level is specified. But support drops to 50 percent if the income is specified as \$40,000 a year or more. Similarly, only four in ten favor raising the taxes that higher-income retirees pay on their Social Security benefits, but two-thirds favor taxing benefits for those earning \$75,000 a year and up.

Social Insurance

Americans are divided over whether they want Social Security in the future to act principally as a social insurance program to ensure that elderly people have a minimum income during retirement (51 percent) or as a program in which people receive money based on how much they pay into the program (42 percent). The younger and older generations differ substantially in their

view. A plurality (48 percent) of adults under age 35 want the program to be based principally on what people pay into it, compared with only 32 percent of those 65 or over.

Privatization

Americans are beginning to stake out their positions on the issue of privatization and alternative investment strategies for Social Security, but they are not yet completely committed to their current views.

Most Americans do not want Social Security to be completely redesigned. But they do favor some private investment of Social Security funds, so long as it is done by individuals rather than by the government (table 1).

Only one-third of Americans want to see the president and Congress completely redesign Social Security. A plurality (44 percent) wants to make changes but preserve the program basically as it is, while another 22 percent want to leave the program alone.

Consistent with their belief that money in the trust fund is not being invested wisely, many people are willing to consider privatization or alternative investment strategies for some Social

Security funds. Depending on how the question is worded, between 64 percent and 80 percent of Americans favor allowing individuals to invest part of their Social Security tax payments. In one survey, however, more than half of those with opinions on allowing individual investment said they could easily change their minds.

On the specific issue of investing Social Security funds in the stock market, public opinion is fluid and strongly affected by how the process is described. In three recent surveys, support ranged from a low of 48 percent to a high of 60 percent.

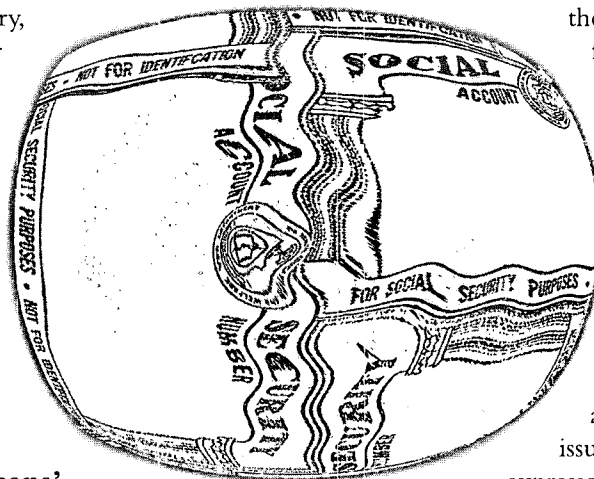
If some Social Security tax funds are invested in the stock market, 80 percent of the public would prefer for individuals to invest part of their own portion, and only 14 percent would prefer for the government to make the decisions.

In five of six surveys only about one in three Americans favors having the government invest Social Security revenues in the stock market. But even on the issue of government investment, where the public's views seem so clear, one survey found more than half of those with opinions on the issue saying that they could easily change their mind.

Surveys so far have not investigated why the public does not want the government to make the investments. Perhaps people fear that the government would not invest the money wisely in the marketplace. Or they may not wish to give the government too much power over the private economy.

Significant disparities in how people of different generations view Social Security may affect the debate over privatization (table 2). Younger adults are far more likely than older Americans to believe that the program is in crisis, see the system as unfair, believe that the program should be completely redesigned, and favor private investment of a portion of Social Security funds.

Seniors, for whom the stock market crash of the 1930s is a vivid memory, are much more leery than other Americans of investing Social Security funds. Far fewer seniors than younger adults favor people having individual accounts and making their own investments with a portion of their Social Security payments. Similarly, seniors show far less support than younger adults for government investment of Social Security funds in the private stock market.



Social Security and Americans' Attitudes about Retirement

The public's reluctance to take action on Social Security is due to more than one cause, but clearly a major reason is that they are as concerned about not being able to save enough for their own retirement as they are about the long-term future of Social Security. Seven out of ten working adults report that they are worried about not having enough private savings for their own retirement. Average citizens are in a quandary, trapped between their fear that there will not be enough funds left in the Social Security system and their concern about not having enough money in their own private savings when they stop working.

Most working Americans know they cannot expect to live comfortably in retirement on Social Security benefits alone. While seven in ten believe that an average retired person needs a yearly income of at least \$20,000 to live comfortably, nearly nine in ten know that the average annual benefit now paid to a retired worker by Social Security is less than that. For someone to live comfortably in retirement, Social Security must be supplemented by private savings, especially if the Social Security benefit is reduced.

People are painfully aware of the gap between what they are now saving privately and what they need to retire comfortably. Working adults report that they are saving half what they think is necessary. In fact, six in ten report that they saved less than \$3,000 for their retirement during the past year. More than half of working adults say they are either not saving for retirement at all (31 percent) or are saving inadequately (26

percent). Strikingly, the figure is almost identical for those aged 50–64, who are closest to retirement.

As to private pensions, which most working adults anticipate as being a larger source of retirement income than Social Security, 45 percent report that they do not participate in an individual or employer-provided private pension or 401(k) plan. Once again, those near retirement are no better off: 44 percent of adults aged 50–64 are not enrolled in such plans.

Poorer Americans are among the most vulnerable. Nearly nine in ten of those earning under \$20,000 a year are either not saving for retirement at all (61 percent) or are saving inadequately (25 percent). Two out of three of those who have yet

to begin saving for retirement explain that they do not have anything extra to save for the future, and only one in five adults earning under \$20,000 is participating in a 401(k) or private pension program.

Taken together, these surveys portray a nation in a state of denial. Americans recognize both that Social Security faces serious financial difficulties and that they are not saving enough personally for retirement. But they are unwilling to face up to either issue. "Maybe next year" is the view expressed quite widely in opinion surveys.

Surprisingly, even the age group closest to retirement takes the same view

POLLS USED

The polls cited include the *Time/CNN/Yankelovich Partners* poll of January 8, 1997; the *Princeton Survey Research Associates/Newsday* poll of January 9, 1997; the *NBC News/Wall Street Journal* poll of January 15, 1997; the *Los Angeles Times* poll of February 5, 1997; the *Washington Post/Henry J. Kaiser Family Foundation/Harvard University* poll of March 13, 1997; the *Gallup/CNN/USA Today* poll of June 26, 1997; the *Associated Press/ICR* poll of March 27, 1998; the *Time/CNN/Yankelovich Partners* poll of April 8, 1998; the *NBC News/Wall Street Journal* poll of April 18, 1998; the *American Viewpoint Battleground 1998* poll of April 22, 1998; and the *Harvard University/Chilton* poll of May 6, 1998. Results for all the polls cited may be obtained from the Roper Center for Public Opinion Research, Storrs, Connecticut.

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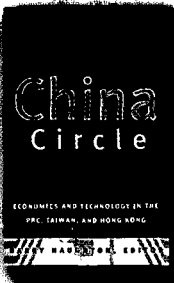
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